Daiwa Capital Markets

Hong Kong Property Sector

Negative | Neutral | Positive

Positive
(unchanged)

It’s time to be more greedy than fearful

- Challenges abound, but we think the Hong Kong property market is more mature and sophisticated than many observers realise
- Corporate fundamentals are stronger than industry fundamentals – a distinction that we think deserves more recognition
- Significant investment value could be unlocked if family-owned property companies continue to modernise; reiterating Positive stance

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See important disclosures, including any required research certifications, beginning on page 175

Sector

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What's new: In this report, we look at how the physical property market has responded in the face of widespread pessimism towards Hong Kong property in the past few months. We conclude that the sector is not heading for the kind of meltdown scenario that share prices appear to be pricing in.

What's the impact: Can the Hong Kong property market avoid a meltdown? In our view, the Hong Kong property market is more mature and sophisticated than many observers realise. While other property markets facing contradictory forces of a similar scale have succumbed to sustained slumps, the Hong Kong property market has survived – and even thrived – over the past few decades, and does not appear to be heading for a meltdown today. Rather, we believe the current situation could well be simply a correction, or a return to normalisation from the unusual circumstances the market has faced since 2H03. Indeed, if market participants respond to today's challenges in a proactive and sophisticated way, it is not inconceivable that these challenges will turn into catalysts, taking the sector to the next level as a metropolitan property market.

The traditional valuation swings in Hong Kong property stocks provide upside potential for share prices. Historically, Hong Kong property companies' share prices have recovered strongly, and quickly, when the market has accepted it has over-discounted the downside for the physical market. If the experiences of 2H05, 4Q08 and 2H13 are anything to go by, we could see a 50-150% share-price rebound in a few months. Moreover, we see room for further share-price upside if the family property companies continue to modernise the way they manage their assets and allocate capital. We see improvements in capital management as being key, and note that many of these companies have been growing their DPS for over 10 years, while some have begun to accept share buybacks.

What we recommend: We still see considerable value in the sector, and hence maintain our Positive stance. Our top picks among the landlords are Swire Properties (1972 HK, HKD19.90, Buy [1]) and Hongkong Land (HKL SP, USD6.08, Buy [1]), while our top developer picks are Henderson Land (12 HK, HKD44.45, Buy [1]) and SHK Properties (16 HK, HKD86.95, Buy [1]). Also, we initiate coverage of Cheung Kong Property (1113 HK, HKD45.25) with a Buy (1) rating.

How we differ: We expect the Hong Kong property market to be more resilient than share prices seem to be pricing in. Moreover, we discern signs of change in these companies' capital management, and if this trend continues, the hidden investment value of these shares (worth up to USD100bn, on our estimates) could be gradually unlocked.

Key stock calls

	New	Prev.
Swire Properties (1972 HK)		
Rating	**Buy**	Buy
Target	**30.70**	30.70
Upside	▲ **54.3%**	
Hongkong Land (HKL SP)		
Rating	**Buy**	Buy
Target	**8.50**	8.50
Upside	▲ **39.8%**	
Henderson Land (12 HK)		
Rating	**Buy**	Buy
Target	**60.80**	60.80
Upside	▲ **36.8%**	
SHK Properties (16 HK)		
Rating	**Buy**	Buy
Target	**131.60**	131.60
Upside	▲ **51.4%**	
Cheung Kong Property (1113 HK)		
Rating	**Buy**	
Target	**71.00**	
Upside	▲ **56.9%**	

Source: Daiwa forecasts

Negative | Neutral | **Positive**

Positive
(unchanged)

How do we justify our view?

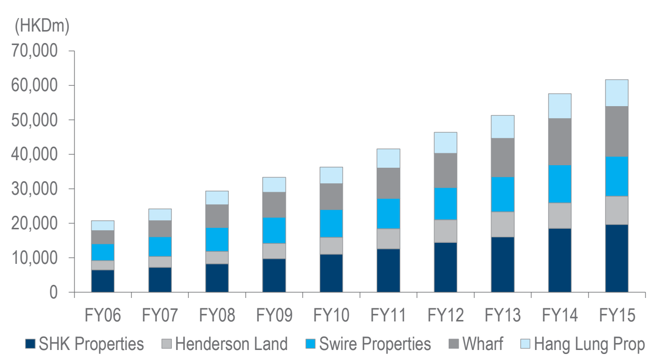
Growth outlook	Valuation	Earnings revisions
✔ ✔ ✔ ✔ ✔	✔ ✔ ✔ ✔ ✔	✔ ✔ ✔ ✔ ✔

Growth outlook

While property sales profits in the residential segment can be volatile, the Hong Kong landlords and developers generally delivered respectable YoY rental income growth for 2015. Meanwhile, their China earnings have been growing consistently, to the point where 7 companies now have annual China gross rental incomes exceeding HKD2bn – 2 of which are over HKD3bn.

The latest results confirm that the Hong Kong property companies' rental income has been holding up, even for retail properties. This should cushion them against market headwinds going forward, in our view.

Aggregate rental income of 5 major property companies



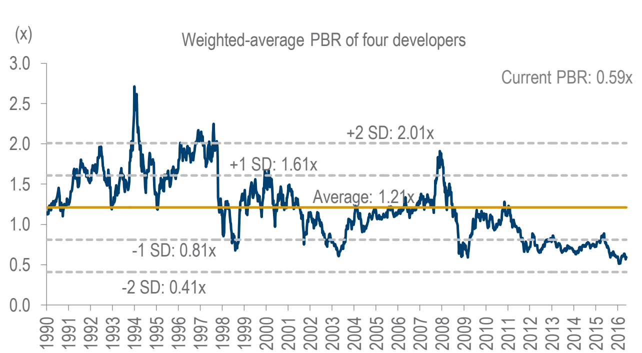
Source: Companies

Valuation

While the share prices of the Hong Kong landlords and developers have not fallen that much in absolute terms, we believe the sustained growth in their book values, NAVs and recurrent incomes over the past 10 years is not reflected in their share prices currently. The result: expanding discounts to both book values and NAVs.

After performing well in 2014 and 1H15, these shares saw a major sell-off in the broader market correction recently. As a result, on PBR and P/NAV, their valuations are now at about past-crisis levels (GFC, SARS, Asia financial turmoil), or have breached the lows seen in these crises, despite their much-improved corporate fundamentals.

Major Hong Kong property developers: PBR



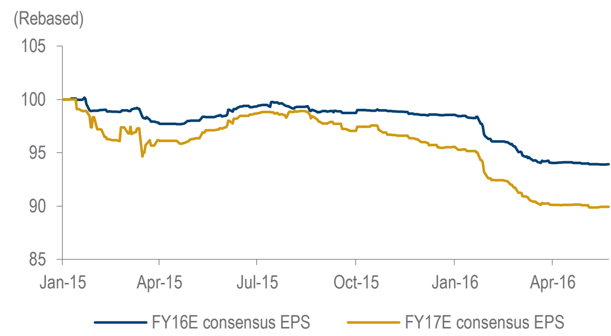
Source: Companies, Datastream, Daiwa

Earnings revisions

The Bloomberg-consensus earnings and NAV forecasts have been trending down for some time, which we take as evidence that some pessimism is built into share prices. Our take on the latest results is that the rental income and earnings of most Hong Kong property companies were stronger than the market had expected.

Meanwhile, large transactions are still going through in the physical market. We expect Mainland capital to continue to support property asset purchases and note a growing acceptance among Hong Kong property companies of recycling capital through non-core asset disposal. This suggests to us there is considerable room for the market to revise up its earnings and NAV forecasts for the sector.

Hong Kong property companies earnings revisions



Source: Bloomberg, Daiwa

Sector stocks: key indicators

Company Name	Stock code	Share Price	Rating		Target price (local curr.)			EPS (local curr.) FY1			EPS (local curr.) FY2		
			New	Prev.	New	Prev.	% chg	New	Prev.	% chg	New	Prev.	% chg
Cheung Kong Property	1113 HK	45.25	Buy		71.00			4.484			4.976		
Hang Lung Properties	101 HK	14.22	Buy	Buy	23.70	23.70	0.0%	1.194	1.194	0.0%	1.430	1.430	0.0%
Henderson Land	12 HK	44.45	Buy	Buy	60.80	60.80	0.0%	3.884	3.884	0.0%	4.408	4.408	0.0%
Hongkong Land	HKL SP	6.08	Buy	Buy	8.50	8.50	0.0%	0.372	0.372	0.0%	0.421	0.421	0.0%
Hysan Development	14 HK	31.60	Buy	Buy	46.60	46.60	0.0%	2.412	2.396	0.7%	2.594	2.576	0.7%
Midland	1200 HK	2.03	Hold	Hold	2.01	3.15	(36.2%)	(0.165)	0.127	n.a.	0.114	0.191	(40.6%)
MTR Corporation	66 HK	35.85	Outperform	Outperform	42.70	42.70	0.0%	1.508	1.508	0.0%	1.773	1.773	0.0%
SHK Properties	16 HK	86.95	Buy	Buy	131.60	131.60	0.0%	8.915	8.915	0.0%	10.577	10.577	0.0%
Sino Land	83 HK	11.40	Outperform	Outperform	13.00	13.70	(5.1%)	0.938	0.938	(0.0%)	0.945	0.945	(0.0%)
Swire Properties	1972 HK	19.90	Buy	Buy	30.70	30.70	0.0%	1.386	1.386	0.0%	1.540	1.540	0.0%
Wharf Holdings	4 HK	41.35	Buy	Buy	63.50	63.50	0.0%	4.050	4.050	0.0%	4.578	4.578	0.0%

Source: Bloomberg, Daiwa forecasts

Daiwa forecasts for Hong Kong property prices

	2014	2015	2016E
Rents			
Shopping malls	+6%	+3%	-5%
High Street shops	na	-30%	-20%
Overall retail	+6%	+3%	-6%
Central grade-A office	+4%	+15%	+5%
Overall office	+4%	+8.5%	+5%
Mass-residential property	+7%	+4%	-10%
Prices			
Mass-residential property	+11%	+3%	-10%

Source: CEIC, CBRE, Jones Lang La Salle, Savills, Midland, Centa-City leading Index, Daiwa forecasts

Daiwa forecasts for residential property market transactions

	2015	2016E	2017E
Primary market transaction			
- volume (no. of units)	16,799	10,800	10,800
- value (HKDm)	162,221	91,800	91,800
- average price per unit (HKDm)	9.7	8.5	8.5
Secondary market transaction			
- volume	40,872	30,000	32,000
- value	255,457	174,000	185,600
- average price per unit	6.3	5.8	5.8

Source: Daiwa forecasts

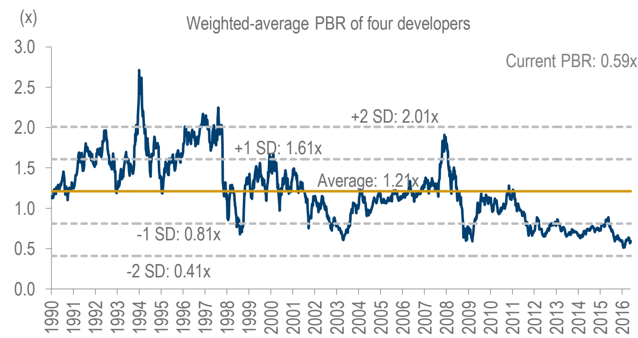
1. The physical market showed restraint and prudency during 2H03-2015

Meltdown scenario conceivable, but looks unlikely

The stock market seems to have a pessimistic view of the impact of the retreat of the "2 tidal waves"

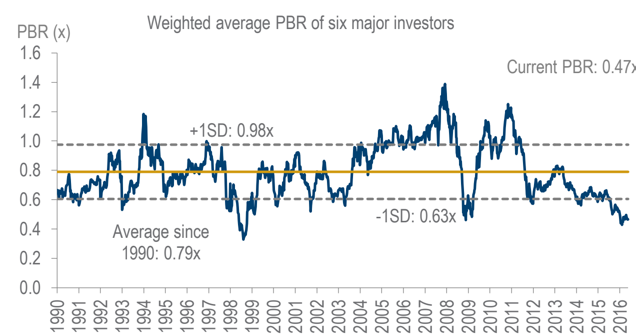
Many investors in the Hong Kong stock market currently hold the view that the outlook for the Hong Kong property sector is gloomy, and this has shown in the valuations of the Hong Kong property stocks over the past few months. We think such pessimism is understandable given that the Hong Kong property market has benefited from what we term the '2 tidal waves' – exceptionally low interest rates and the rise of Mainland Chinese as a new and important group of shoppers globally – and now these tidal waves appear to be retreating. (Note: the state of China's economy has been cited by some as being another tidal wave to have benefited Hong Kong's property market in the past. However, we think the impact of China's economy is more subtle and complex than many recognise, and we intend to explore this issue in a follow-up report.)

Major Hong Kong property developers: PBR



Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



Source: Companies, Datastream, Daiwa

On the face of it, Hong Kong as a metropolitan city seems an "impossible proposition"

We do not disagree that a meltdown scenario for Hong Kong property is conceivable. However, the Hong Kong property market has faced seemingly crisis-like situations many times in the past, and one of the most noteworthy characteristics of the market is that it has been developing and maturing despite, and amid, such crises and challenges. This situation is more than coincidence in our view; and it might in fact be that the challenges and crises have helped drive the development of the Hong Kong property market, because the need to survive has forced many market participants to continue innovating and adapting.

In terms of having to face and cope with crises, there are few parallels in other markets globally that can compare with Hong Kong. And although its track record does not guarantee that the Hong Kong property sector will overcome challenges again, we make the case that the sector deserves the benefit of the doubt this time round.

To put the current situation in the Hong Kong property market into perspective, we took a look at how the market has developed over the past few decades. In truth, it could seem an "impossible proposition" that Hong Kong would become a metropolitan city and an international financial centre given its unsuitable topography, size, and land-supply mechanism. Moreover, it is such a small city (total area of about 1,000 sq km, of which Hong Kong Island accounts for about 80 sq km, representing less than 10% of the area of London or New York City), yet is closely linked to the 2 largest mega-sized economies in the world (Mainland China and the US).

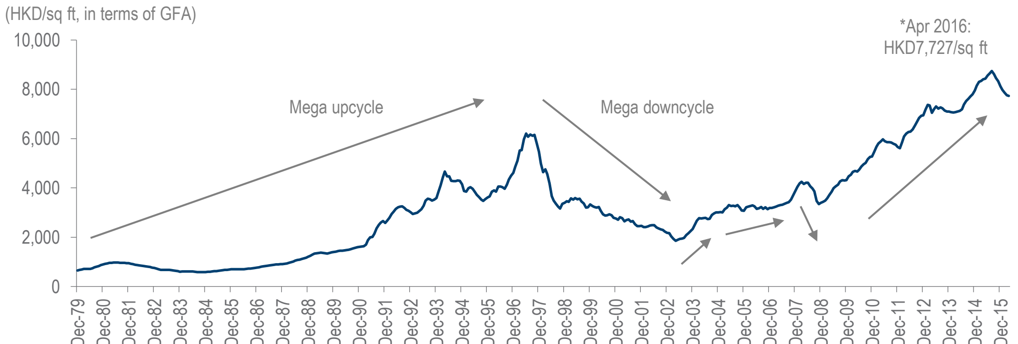
In terms of its monetary system, one could argue that the dollar peg has turned Hong Kong into another US state. Nonetheless, as regards its real economy, a significant and growing part of it depends on China, yet the US and Mainland economies are fundamentally and structurally different, particularly in terms of their stage of development.

In our view, 1983 was the watershed year for the Hong Kong property market because that was the year the local currency was pegged to the USD at a rate of USD1 to HKD7.8. From that point on, the Hong Kong property market became an anomaly in global property, in that the world had never seen a property market affected by such divergent forces, with each force being so much larger than the Hong Kong economy itself.

There have been few property markets in the world buffeted by such contradictory forces as Hong Kong

Given the contradictions and constraints the Hong Kong property market has encountered over the past 3 decades, it is quite an achievement that the market has not crumbled. On the contrary, Hong Kong's property market has continued to evolve and develop. This, however, is not to belittle the contradictions, volatility and challenges the market has faced, and continues to face. Our view is that the "US interest rate but Chinese economy" structure is a recipe for significant volatility in asset prices and property demand in Hong Kong, as has been seen in the past (see following charts). We will however argue that the downturn during 4Q97-2Q03 was not caused mainly by macroeconomic factors. Rather, we believe that the main reason was the change in Government land sale policy that has removed the floor value or the perceived floor value of land in Hong Kong which we see as the foundation of the Hong Kong property market.

Hong Kong residential property market: prices since 1979



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

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%	4.6x
Class A	8.9x	-67%	5.2x
Class B	10.4x	-66%	4.4x
Class C	12.7x	-66%	4.1x
Class D	na	-64%	3.9x
Class E	na	-63%	3.6x
Office			
Overall	7.7x	-73%	7.6x
Grade A	8.5x	-73%	6.8x
Grade A - core districts	na	-73%	6.5x
Grade B	7.4x	-74%	8.4x
Grade C	6.1x	-72%	8.1x
Retail			
Overall	11.2x	-61%	6.5x

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

Why has the Hong Kong property market not collapsed several times already?

Given the significant volatility in property prices in Hong Kong in the past, it is noteworthy that the Hong Kong property market has not seen any major corporate failures since the early 1980s. The reasons for this are complex and varied, and beyond the scope of this report. Suffice to say, we believe the ability of market participants to learn from experience, as well as the market's ability to self-correct, have been the main forces that have protected the Hong Kong property sector in the past. And we believe the existence of such forces deserves greater recognition by investors.

In our opinion, the experience and prudence of the participants in the Hong Kong real estate sector are unusual amid the global property market – and this is the case for a reason. Few, if any, other markets in the world are dominated by players that have 4 or so decades of experience in the industry and are still managed by more or less the same group of people. Moreover, the balance sheets of Hong Kong property companies look very conservative by global standards, as few other markets have players that are so lowly geared – a situation that ensures the Hong Kong property companies could weather a crisis should one break out tomorrow.

Has the world's most dangerous property market evolved into one of the most prudent?

Is Darwin's survival of the fittest theory the saving grace for the Hong Kong property?

In retrospect, we think Darwin's "survival of the fittest" theory applies to Hong Kong property sector in that those companies that have survived have acquired/developed/exhibited the unusual trait of always being alert to potential crises. Note that prior to 1983, Hong Kong had experienced some of the most severe property market downturns the world had ever seen (property prices in Hong Kong collapsed by over 60% in both 1965 and 1981, later accompanied by major corporate failures, banking crises and social riots [ie, in 1965]); while over 1983-2003, the city saw some of the largest challenges arguably ever experienced by any property market in the world, namely the Tiananmen Square crackdown in 1989, the Handover by the UK to Mainland China in 1997, the Asia Financial turmoil and attacks on the HKD peg in 1998 and the 6 years of downturn in Hong Kong property over 4Q97-2Q03, which saw residential and office capital values falling by as much as 70% from peak to trough.

Hong Kong residential property prices: major tipping points

Events that negatively affected the residential property market	Period	Maximum drop in residential property prices
June 4th - 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

As such, participants in the Hong Kong property sector (ie, developers, banks, end-users, investors, regulators) are also survivors of these shocks. Indeed, many of today's largest property companies in Hong Kong have managed to stand out from the crowd (while the Hong Kong property industry is now dominated by only a few players, it was very fragmented in the 1960s and before, with hundreds of players) mainly because they were able to survive and capitalise on the depressive land market in the territory in the aftermath of the banking crisis in 1965 and social riots in 1967 which triggered a collapse in the property market. In short, the major players in the Hong Kong property industry generally have well over 4 decades of experience of operating in a highly volatile and turbulent property market, and not many property markets in the world can boast of participants with the same experience.

The 4Q97-2Q03 downturn is critical in terms of putting the current cycle into perspective

Importantly, we think the 6-year downturn over 4Q97-2Q03 provides the context to understand how the Hong Kong physical market has responded to the aforementioned 2 tidal waves and to put the market's response into perspective. In our opinion, in the face of the 2 tidal waves to have hit Hong Kong since 2H03, one would have expected market participants to respond by substantially leveraging up, and many marginal buyers to have entered the physical market and many newcomers to have joined the property industry. This would then have sent land and property prices through the roof or to levels reflecting exuberance, until a trigger occurred that led to a major unwinding. While one would expect the above to be the "normal response" to the circumstances the Hong Kong property market has faced since 2H03, this has not happened in the Hong Kong context. Indeed, one might say that what has happened features some elements of the opposite.

A price meltdown driven by a vicious cycle is conceivable; but is this scenario playing out now?

We concur with the market in assuming that the triggers leading to a receding of the 2 tidal waves have occurred and that they could drive a meltdown of the Hong Kong property market. In our view, a typical meltdown scenario for the property market would be a collapse in demand, followed by the property companies cutting prices and rents to ensure they can lock in demand before such demand vanishes. In the meantime, the traditional bargain-hunters (in Hong Kong, this would include well-capitalised companies, individuals and Hong Kong's old families) could choose to exit the market for the time being and not bother bottom-fishing as the meltdown could take years to fully play out. These developments, in turn, could result in fears in the market spreading to the wider economy, resulting in a deteriorating job market. Meanwhile, the banks would hesitate to lend, resulting in contracting credit and rising credit spreads. Then, a vicious cycle would take hold of both the property market and economy, leading to a prolonged downward spiral in prices.

We see the above as a logical development under a typical "euphoria and then meltdown" scenario and believe it could happen in Hong Kong. The question, though, is: how likely is it to occur? We think the answer depends on 1) : "did such euphoria take hold in the Hong Kong property market over 2H03-2014, and 2) have the property markets been showing signs of a meltdown scenario over the past few months?

Paradoxically, it might turn out that because the Hong Kong property market has been so volatile and turbulent in the past – and that most players still have vivid memories of such turbulence – the current cycle is much more restrained and sustainable than many expect. This is a possibility/scenario that we highlight in this report, and others to follow.

Just how euphoric was the property market from 2H03-2013?

Has the market already been holding back?

In our opinion, when the 2 tidal waves were moving in favour of the Hong Kong property market over 2H03-2013, euphoria might not be the most accurate word to describe the mood. Granted, we did see some signs of excesses, but they appear to have been limited to select segments (such as rental levels for high-street shops in the retail sector, and office rents in Central over 2H03-2010), but the optimism shown up in these segments did not really develop into an across-the-board phenomenon for the sector as a whole.

Indeed, our read is that many other segments in the same sector were quick to upgrade so as to position themselves as alternatives to the most sought-after segments, which provided a kind of force restraining the magnitude and breadth of excesses in those segments. In short, it does not appear to us that any of the 3 major sectors of Hong Kong property (ie, office, retail or residential) saw their entire spectrum being characterised by euphoria during 2H03-2013. Nor did we see many inexperienced or new marginal buyers enter the league of buyers or property companies during the same period.

Above all, various psychological barriers that had been prevalent in Hong Kong in the past were broken during this period (2H03-2013), which we see as natural market forces emerging to counter-balance the excesses seen in the top end segments of the respective markets. Among them included companies accepting relocating across the harbour; international retailers accepting and moving into malls in the New Territories; the rise of East Kowloon as an office hub and that of the suburban malls; the upgrading of Tseung Kwan O from a residential market for home-starters into a market for the middle class and professionals.

In any case, we do not think either Hong Kong property companies or flat owners themselves have been heavily over-leveraged, in the sense that, from 2H03 to now, we do not see any evidence that any sector as a whole has taken on debt to a level that has stretched its ability to afford the interest burden, even assuming interest rates normalise soon. True, the debt to GDP ratio in Hong Kong has been rising since 2H03, but we think this is a misguided way to look at the issue of potential over-leverage in Hong Kong.

Is there system-wide over-leveraging in Hong Kong?

Suffice to say, Hong Kong has long over-taken Switzerland as No.1 in the world in terms of the size of its asset market relative to its GDP. Since the value of residential property assets in Hong Kong is high (over 2.5x of GDP), so annual residential property transactions would be certain to materially boost total mortgage loans outstanding in Hong Kong, as long as not all residential purchases are financed by equity. However, between 2003 and 2015, the annual net increase in residential mortgage loans outstanding in Hong Kong (HKD551bn) represented just 12.5% of the total value of residential property transactions during the period (HKD4,422bn), which is probably one of the lowest, if not the lowest, in the world. We think this situation reflects that: 1) buyers in Hong Kong often put up a significant amount of equity when purchasing larger flats, and 2) the repaying of principal loans outstanding has been fast under a low interest rate environment – indeed, our observation is that, instead of leveraging up, many property owners in Hong Kong have used the low interest rates to shorten their repayment period so as to pay off their mortgages faster.

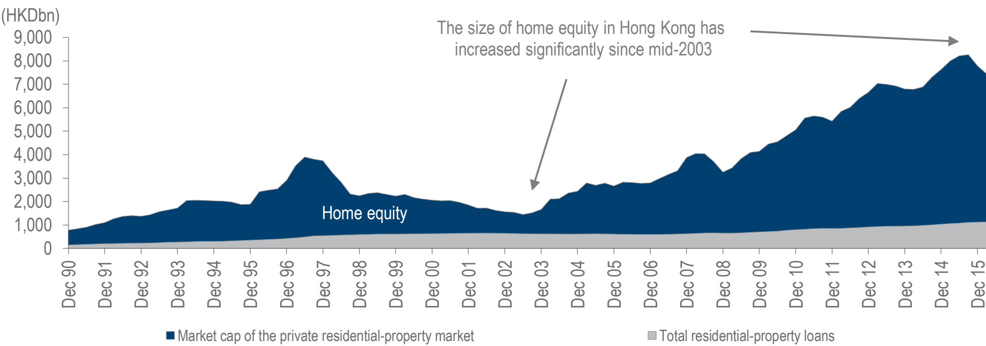
The banking aspect of the Hong Kong residential property market

(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

In our opinion, when evaluating the extent of over-leveraging in a property market, one should compare the level of debt in the system relative to the total market value of the underlying assets and the income they generate in a year. However high Hong Kong's mortgage loan outstanding might be in relation to GDP, it represents less than 20% of the current market value of those assets which is probably one of the lowest in the world. In short, since the size of Hong Kong's asset market (property plus equities) is large relative to its GDP (over 4x excluding equities and over 15x after including equities), merely a rising level of debt versus GDP may not be the appropriate and conclusive way to analyse the issue of leverage in the Hong Kong context.

Hong Kong: home equity



Source: Midland, CEIC, Daiwa

Government has been using administrative measures to pre-empt the formation of any asset bubble

Indeed, we believe market participants have demonstrated an unusual level of restraint and discipline over the past 12 years in terms of leverage and their response to the exceptionally low interest-rate environment. The policies of the central banks have played a role, too. This time around, the Asian central banks (especially those of Singapore and Hong Kong) have aggressively pre-empted the formation of any major asset bubbles by adopting draconian administrative measures to prevent buyers from taking on additional leverage or buying more property assets.

Government measures related to Hong Kong property

Government measures: details of the special stamp duty (SSD) imposed since November 2010

	Before Feb 2013	Since Feb 2013
The SSD		
Length of the SSD period	2 years	3 years
Resale within 6 months	15%	20%
Resale in 6-12 months	10%	15%
Resales in 12-24 months	5%	10%
Resale in 24-36 months	nil	10%
Buyers' stamp duty		
- Permanent HK residents	Nil	Nil
- Purchases using company	Nil	15%
- People working/ living in HK but without permanent-resident status	Nil	15%
- Foreign buyers not living or working in HK	Nil	15%

Source: HK Government

Maximum LTVs (Loan-to-valuation) on residential mortgages in HK

Date	<HKD7m	HKD7-8m	HKD8-10m	HKD10-12m	HKD12-20m	>HKD20m
Before Oct. 2009	70%	70%	70%	70%	70%	70%
Oct 2009 onward	70%	70%	70%	70%	70%	60%
Aug 2010 onward	70%	70%	70%	70%	60%	60%
Nov 2010 onward	70%	70%	60%	60%	50%	50%
June 2011 onward	70%	60%	60%	50%	50%	50%
Sept. 2012 onward	70%	60%	60%	50%	50%	50%
Feb 2013 onward	70%	60%	60%	50%	50%	50%
Feb 2015 onward	60%	60%	60%	50%	50%	50%

Source: HKMA, HK Economic Times, Daiwa

Maximum LTVs (Loan-to-valuation) on residential mortgages in HK

	First property		Subsequent properties	
	With HK income	Without HK income	With HK income	Without HK income
Self-occupy units				
< HKD7m	60%	50%	60%	40%
HKD7-8m	60% (cap. at HKD5m)	50% (cap. at HKD5m)	60% (cap. at HKD5m)	50% (cap. at HKD3m)
HKD8-10m	60% (cap. at HKD5m)	50% (cap. at HKD5m)	60% (cap. at HKD5m)	50% (cap. at HKD3m)
HKD10-12m	50%	40%	50%	30%
HKD12-20m	50%	40%	50%	30%
> HKD20m	50%	40%	50%	30%
Units not for self-occupation	50%	40%	50%	30%
Net-worth based mortgages	40%	40%	30%	30%

Source: HKMA, HK Economic Times, Daiwa

The rise in prices has created large windfalls for those who bought their property assets early

While Hong Kong property prices have risen considerably since 2H03, such a rise was not driven by widespread excessive leveraging or the entry of many inexperienced and overleveraged newcomers. Instead, our read on how leverage has evolved in the system is that along the way, the sector has exhibited an unusual level of restraint and discipline, probably driven as much by experience and the scars from the downturn of 4Q97-2Q03 as by foresight. In short, property prices in Hong Kong have been strong since 2H03 not because of leverage. Rather, they have been strong despite an unusual level of restraint in the use of leverage by the market participants as a whole. Note also that rents – be they retail, office or residential – have also risen considerably since 2H03, and the rental market should not be affected much by leverage. Hence, while popular belief has it that the Hong Kong property market's performance during 2H03-14 was driven by low interest rates, we think this is a misguided perception upon closer inspection.

In this connection, note that the stance taken by the Hong Kong regulators since 2011 has made it very difficult for system-wise over-leverage to happen, as it has imposed some unprecedentedly strong administrative measures to prevent over-leveraging and excessive optimism from forming. We do not dispute that some market participants could have over-leveraged, but for the system as a whole, we do not see evidence of any over-leveraging.

As such, while Hong Kong's property prices have risen considerably, sizeable windfall bonuses have gone to those who bought early. As far as we can tell, there does not appear to have been much misallocation of capital in the market, in the sense that we do

not see many decisions having been taken by either corporates or individuals seemingly based on the positive extrapolation of the current situation, or excessively financed by the use of debt.

Hong Kong property companies: net gearing ratios

Company	Dec 2014	Dec 2015	YoY chg
CK Property	na	5.7%	na
Great Eagle	Net cash	Net cash	na
Hang Lung Properties	Net cash	1.1%	na
Henderson Land	15.7%	16.0%	+0.3pp
Hongkong Land	10.0%	8.0%	-2.0pp
Hysan	4.2%	3.0%	-1.2pp
Kerry Properties	28.5%	32.2%	+3.7pp
MTRC	7.6%	11.3%	+3.7pp
New World Dev	13.0%	13.0%	0.0pp
SHK Properties	13.8%	12.4%	-1.4pp
Sino Land	Net cash	Net cash	na
Swire Properties	16.3%	15.3%	-1.0pp
Wharf	18.9%	14.9%	-4.0pp
Wheelock	18.8%	16.0%	-2.8pp

Source: Companies, Daiwa

Property companies have been using gains to invest in China ....

Indeed, we have seen hardly any signs of the major listed companies we cover opting for significant leveraging in order to embark on ambitious property projects in Hong Kong. Instead, they seem to have deployed any windfall gains made from their Hong Kong businesses to scale up their China presence; and the harvesting time for such investments appears to have started coming through for many of them since about 2012.

In this light, Hong Kong's physical property market and the Hong Kong property companies themselves seem to have treated the 2 tidal waves as a kind of windfall rather than as a situation they are counting on to last. However, we do not think they made the most of these 2 tidal waves when they were moving in their favour, and as such when now the waves have started to retreat, the impact on these players may well be much more significant than some expect.

2. Is the physical market showing signs of a potential meltdown?

The market is prepared for the eventual retreat of the 2 tidal waves

While the news headlines lines relating to the retreat of the 2 tidal waves became prominent only in 2H15, we think these 2 tidal waves have actually been retreating since 1H14 and that some market participants could have been preparing for this scenario for some time.

The normalisation of US interest rates is not unexpected

We note that the Fed started sending signals to the market that it was going to move towards tapering in 2013. Meanwhile, the momentum created by mainland spending in Hong Kong stores started to slow in 1H14, probably due to the cumulative impact of China's anti-corruption campaign and also because that level of spending (in terms of the ticket size of some individuals, often over USD500k) was unlikely to be sustainable.

In the meantime, the Hong Kong Monetary Authority (HKMA) announced stringent measures in February 2013, which, among other things, required the banks to carry out a 300bp stress test on new mortgage loan applications (this means that while flat owners might pay only 2.15% on their mortgages, the loan would be approved at a mortgage rate that was 300bp higher, ie, 5.15%), meaning that even now a 300bp rise in the mortgage rate is already built into the system.

All in all, we believe the retreat of the 2 tidal waves has not surprised the participants in the physical market. In fact, many probably never expected them to last in any case.

Do recent major market transactions point to a meltdown scenario?

Events so far this year don't seem to fit with what a typical meltdown scenario would look like

We do not consider the recent developments in the physical market as a sign of the kind of meltdown scenario we outlined in the previous section.

Granted, the physical market has turned a lot more cautious with limited activity in terms of transaction volume in both the primary and secondary residential property market since late-2015. However, we note that some important transactions have been concluded in the physical market since the latter part of February 2016 (see the table on the next page). Note that these transactions encompass the entire spectrum of Hong Kong property including office, residential and retail properties. This is not what one would expect if a meltdown scenario were about to unfold.

Also, the lump sums involved in these transactions were not small (from HKD500m-10bn). And the achieved prices were not depressed (implied yield range of 1.8-5%). In fact, the achieved prices for some were among the highest ever seen in Hong Kong. Furthermore, the buyers were not new and inexperienced, and could have chosen to invest in China or in other investments, or just wait.

Physical market transactions in Hong Kong since February 2016

Date	Events	Sectors	Details	Remarks
11 April	Link REIT sold 7 more non-core assets	Retail/ car parks	Total proceeds were HKD1.96bn	Implied NPI yield ranged from 3.4-4.3%. The assets were bought by individuals and ticket size looks large at HKD151m – HKD471m
1 Apr	Link REIT sold 2 non-core assets	Retail / car parks	Total proceeds were HKD1.69bn	Implied NPI yield for the 2 assets were 3.3% and 3.8% respectively, on our estimates. These assets were bought by individuals for HKD810m and HKD880m, respectively
16 Mar	K&K Property won the tender for a residential site in Stanley	Luxury residential	The price was HKD2.8bn or HKD12,435/sq ft. Achieved price was below the market forecast of HKD3.8-5.4bn	K&K Property is owned by the Law family in Hong Kong which has had a business presence in Hong Kong for several decades.
10 Mar	Nan Fung won the tender for the Lohas Park Package 10	Residential	The project has total GFA of 811,606 sf. The price was HKD1.68bn or HKD2,044/sq ft	Nan Fung is one of the largest unlisted property companies in Hong Kong.
5 Mar	SHK P won the tender for a residential site in Pak Shek Kok, Tai Po	Residential	The project has a total GFA of 900,516 sq ft. The price was HKD3.48bn or HKD3,864/sq ft. Achieved price was slightly above the market forecast of HKD2.7-3.2bn.	Total investment is more than HKD8bn, on our estimates.
3 Mar	Kerry Properties sold a house at 1 Ede Road in Kowloon Tong for HKD363m	Luxury residential	The house was sold through a tender. It has a GFA of 4,412 sq ft and the achieved price per sq ft was HKD82,253	The super wealthy appear to still be interested in parking wealth in Hong Kong property.
	Goldin Financial Holdings won the tender for the residential site in Ho Man Tin	Luxury residential	The project has a total GFA of 586,035 sq ft. The price paid was HKD6.4bn, or HKD10,889/sq ft. The achieved price was at the upper end of the market's expectations at HKD5.9-6.4bn.	Another example of a Mainland corporation securing a presence in the Hong Kong market.
26 Feb	China Everbright bought the Dah Sing Financial Centre for HKD10bn	Office	The building has a total GFA of 400,113 sq ft. The achieved price was HKD24,992/sq ft. The seller was SEA Holdings.	Another example of a major China corporation seeking to own its office property in Hong Kong.
22 Feb	A house in Mount Nicholson was sold for HKD830m (HKD87,784/sq ft) through a tender, setting a new high for the total unit price of a non-single-lot luxury house in Hong Kong	Luxury residential	The previous record was HKD800m achieved by Skyhigh in 2011. In terms of price per sq ft, however, the highest is still the HKD133,578/sq ft achieved by Skyhigh.	Quite a few luxury units have been sold in recent weeks despite the poor market sentiment. It looks as if the ultra-luxury residential segment could be the first segment to stabilise in the current cycle.
19 Feb	Link REIT won the tender for an en-bloc commercial building in Mongkok for HKD5.91bn	Retail	The gross yield (before stamp duties and AEI work) is about 5%. The property has a GFA of 0.284m sq ft.	Bidders included several major players in Hong Kong such as SHK Properties, Cheung Kong, etc.
				A property offering strategic value as it is located right above Mongkok train station, which is one of the 3 most well-established retail hubs in Hong Kong.
16 Feb	The Lee Kam Kee family bought an en-bloc commercial building in Central (SBI Centre) for HKD1.58bn or HKD35,033/sq ft	Office	The achieved price was the second-highest in Hong Kong. The implied yield, based on the current passing rent, is only about 1.8%.	The same family bought the Infinitus Plaza in Sheung Wan for HKD4.3bn in 2010.
	COLI bought a site in Tuen Mun for HKD2.1bn	Residential	The achieved price was HKD1,848/sq ft and the project is sizeable, with a total GFA of about 1.15m sq ft.	Total investment for this project was not small – COLI told the media that the planned investment was about HKD10bn.
				COLI should have many opportunities to deploy such capital in mainland cities and likely has no urgency to buy land in Hong Kong
				The largest project COLI has taken up in Hong Kong in recent years, in both GFA and total investment.
17 Feb	2 Headland Road (a house that has not fully utilised its GFA) was sold for HKD1.02bn	Luxury residential	The price was HKD60,610/sq ft	The price per sq ft was not particularly high but the price tag of HKD1.02bn seems very high to us. It was reported in the media that the house has not fully maximised its permitted GFA.

Source: Various media reports, Daiwa

Response in the physical market appears calmer compared to 1Q16

Based on the above transactions, it does not appear to us that the physical market has been showing the typical signs of a typical meltdown scenario. Looking back, the macroeconomic environment since late 2015 has been turbulent, with a lot of concerns about China, CNY depreciation, the HKD peg, emerging markets, oil prices, commodity prices, global economic growth, global deflation, etc, having developed into crises of confidence at various points since the end of 2015.

In turn, these issues have resulted in investor concerns about the economies and industry fundamentals Hong Kong, China and the emerging markets. Against this backdrop, we think it is quite an achievement that there has not been a major panic in the Hong Kong physical property market. Indeed, if we deep-dive into how the physical property market has responded and evolved over the past few months, we would probably conclude that the Hong Kong physical property market is more complex and sophisticated than the stock market recognises. We examine this topic more closely in the next section.

3. Is a meltdown likely? The real situation is more subtle and complex

Hong Kong is a more sophisticated market than it first appears

It did look scary, but….

We have already established that there have been concerns and/or events since 2H15 that have sparked investor concerns about the possibility of a meltdown (or a gradual meltdown) taking place in the Hong Kong property market. Admittedly, there have been events (such as falling residential property prices since August 2015, a significant contraction in residential property market transaction volume, a plunge in achieved rents in some high-street shops, some closure of stores by international retail brands, etc.) in the residential and retail property segments that seem to suggest a meltdown might be on the way. However, if we delve deeper into the background and details of these events, we see alternative interpretations. We present our thoughts in the following tables, which is followed by a more thorough analysis of each of the Hong Kong property segments.

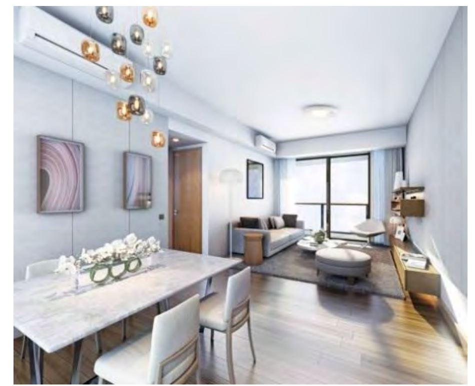
Residential segment

Major events in the property market over the past few months and our interpretation of them

Events	Popular market interpretation	Alternative interpretation	Additional information and remarks
Rapid fall in prices since August 2015 (down 10.4% as at April 2016 – 5.9% decline YTD)	Buying interest is limited and sellers have become increasingly willing to cut prices	Could also be seen as a rational adjustment in the market after a large cumulative rise in prices in the past few years. Note also that government measures implemented since 2010 (those announced in 22 February 2013 were the most severe) have created a "liquidity discount" and "scarcity premium" in the residential property market. Much thinner transaction volume and a wider range in achieved prices is probably the "new normal" as the government measures have been aimed at curbing transactions. When sentiment is bad, sellers have to offer discounts to attract buyers. Conversely, when sentiment is strong, buyers need to offer a premium to get flat-owners to sell.	Residential property prices have gone up by 66% on average since the first government measures were introduced in November 2010. This is especially the case for the smaller units (Classes A and B) where prices have continued to rise by 29.4% and 29.3%, respectively (since the government introduced its most severe measures in Feb 2013), versus 11-13% for the Class C-E units and 13.8% for the sector as a whole. Note however that based on the Centa-City Leading Index, residential property prices have shown early signs of stabilisation as of April 16.
		We think the events during the 4Q97-2Q03 period taught many market participants about the importance of risk management. Hence, during the initial turn in the market's direction (such as during the GFC in 2008), more market participants became willing to sell at a discount to de-risk as quickly as possible. Our read is that the selling seen in the physical market since 4Q15 could have some such elements and it appears to us that by about March, most of the units from the first round of keen selling had been absorbed.	There has been a surge in residential rental transactions – for all segments – since late-2015. We see this as evidence of risk management, reflecting our belief that some flat owners have chosen to rent rather than sell, and hence would rather offer a lower rent to secure a tenant and cash flow, rather than waiting until market sentiment recovers. Once the discounted units have been taken up, and with more units now being leased, the supply of units available in the secondary market could fall notably if there is no trigger for a new round of selling by flat owners. Our market research does not suggest that there are a lot of discounted units for sale available in the market. While some units have been sold at notable discounts, these are not widely available in the market as they tend to be taken up before they are available to the average potential buyer.
		If we delve more deeply into the price data, we can see that there is a divergence in the performance of the different unit classes, with Class A and B leading the fall (by 15.4% and 14.1%, respectively, from August 15-Arpil 2016). In comparison, the Class C and D units have been relatively more resilient, with prices declining by 6.4% and 4.1%, respectively.	We think the Class C and D units are the most indicative of the real market fundamentals and do not appear to be that bad. In other words, we are not seeing signs of a free-fall. We think the price data for Class E units needs to be interpreted carefully as the price range for super-luxury units is very wide and the volume is often limited. It seems that up to April 2016, the trend has been for the prices of the Class A, B and E units to be weak while those for Class C and D have been looking relatively more resilient.
		We think the price correction for Class A and B units is reasonable and arguably overdue. Their stellar performance since February 2013 (ASPs up 29%) has been a distortion created by the government's measures that resulted in investing money moving out of larger units into smaller ones.	After the government announced its measures in Feb 2013, the developers switched into building a larger number of smaller units, but these units did not arrive on the market until 2015. In other words, we think the stellar performances of the Class A and B units from Feb 2013-Aug 2015 was due to the special demand and supply situation (characterised by a sudden increase in demand for small units but limited such units were available in the primary market) that was prevailing at that time, and which no longer applies.

Source: Various media reports, Daiwa

Major events in the property market over the past few months and our interpretation of them (continued)

Events	Popular market interpretation	Alternative interpretation	Additional information and remarks
			The usual tug-of-war between buyers and sellers is going on in the residential property market. Currently, buyers have the upper hand. However, as and when most of the units from keen sellers are taken up, residential property prices could stabilise if there are no major events or factors triggering a second round of major selling. In this light, we think one key factor to monitor is whether a new group of keen sellers emerges in the market. Our base case assumes that there will be a second round of keen selling and we expect the residential property market to stabilise only in 2H16. That said, we haven't seen evidence of a second round of selling emerging in the past few weeks and we think the market seems to have assumed that the selling seen in 4Q15 would just continue into 2016 and beyond, which may not be the case, in our view.
Developers offering various incentives and discounts to attract buyers	Developers are desperate to sell, and their offers of first or second mortgages financed by the developers are a sign of this desperation	We expect the primary market to remain competitive in the foreseeable future. However, competitive pricing is not the same as a vicious price war, which we do not think has taken hold in Hong Kong as of April 2016.	The situation during 4Q97-2Q03, when some developers appeared to be in a vicious price war, was due to the land market at that time – the then-government was eager to sell land irrespective of the price, allowing some developers to engage in a kind of arbitrage between the land and the flat markets at that time. However, the government learned its lesson and we do not expect it to offer land in the same way as it did then. As such, we do not expect a repeat of that land market situation.
		If the developers are expecting selling prices to plunge, they should offer discounted prices to offload the units as quickly and as completely as possible. Having second/ first mortgages offered by the developers is complicating matters significantly with prices continuing to fall. Meanwhile, the Hong Kong developers have a long tradition of offering top-up financing to buyers during uncertain times. Some of these plans were also available when market conditions were good, in earlier years, although few buyers made use of them.	
Major developers not winning various land tenders – albeit that, the situation seems to have improved since March	Experienced players are bearish about the outlook for residential property prices	We think the land tender results suggest that developers are generally cautious about the outlook for the residential property market, but there may not be much more we can ascertain at this point. While popular theories suggest that the bidding prices of the major developers implies they are factoring in a decline in residential property prices, our understanding is that traditionally, the HK property developers do not tend to make bids based on any hard forecasts of flat prices several years later. Historically, there have been many instances of developers, big and small, miscalculating both the potential upside and downside in future prices. Neither are they obliged to bid whenever there is the room for profits; hence we do not think one can infer that their bidding price implies that they think profits can be made from a project only if land prices are at their bidding level. Generally speaking, the HK developers tend to prioritise their interests in different sites based on multiple considerations, not least the site's strategic fit with their other projects, the potential for finished products to be marketed at a higher grade than existing ones, each developer's eagerness to put in extra capital to the Hong Kong property market at that particular point of the cycle, etc.	We think the land market in Hong Kong is characterised by the existence of a few major incumbents that entered the industry early and have been using sales proceeds from existing projects to fund landbank replenishments or expansion. They tend to accept lower built-in margins when the visibility of future cash flows from property sales is strong and, at the same time, they tend to wait on the side lines if the sector's outlook looks blurred. As such, the main conclusion we can draw from the land tender results is incumbents' appetites to raise their landbank exposure and whether there are newer entrants keen to secure a greater presence in the sector.
Swire Properties' ALASSIO in Mid-levels			

Source: Various media reports, Daiwa

Major events in the property market over the past few months and our interpretation of them (continued)

Events	Popular market interpretation	Alternative interpretation	Additional information and remarks
		One structural issue that the land market in Hong Kong has yet to fully come to terms with, in our view, is the large rise in construction costs over the past few years. This should have pushed down land prices by now but we have seen little sign of this happening so far, probably partly because the incumbents still look keen to defend their market presence while the new entrants and those without sufficient landbank are still keen to expand their landbank. We also note that since March 2016, there has been a pick-up in land purchases by the experienced players. SHKP and Nan Fung, both experienced players, bought sites in March. Henderson Land has been buying units in old buildings in recent months and there are no signs of this stopping. Our take is that at least some of the major incumbents and experienced players have used the weak market sentiment to buy their desired sites.	Our read about the various land tenders over the past few months is that it's normal for the major incumbents to have not been keen to take part during periods of market uncertainty – this is in line with their historical patterns. And this may not necessarily mean that the outlook for residential property prices for the coming years must be weak. Note that both Sino Land and Hang Lung Properties bought many residential sites in 1999-2002 just after the 1997 Asian financial crisis, when there was little competition and both have made sizeable profits from the land they acquired at that time. In our opinion, it is hard for new entrants to buy land at attractive prices in "normal" times and it is probably only in uncertain times that they can buy sizeable land with a reasonable safety margin built into the price. Our take on the land market situation over the past few months is that there are some new entrants that have tried to take advantage of the weaker market sentiment to strength their presence in the sector. In the residential property sector, we think the most important transaction so far is COLI's acquisition of a Tai Po site for HKD2.1bn, while K&K's (a private company owned by the Law family) acquisition of a Stanley site is another example. Although the achieved price per square foot of KK's project was reported to be more than 30% below the market estimate, we think the total investment for the project (estimated to be over HKD5bn) was not small for K&K. Moreover, demand for super-luxury units (we estimate that the cost for each completed unit is likely to be over HKD20,000/sq ft) can be very volatile especially in the current market environment, meaning that there are considerable uncertainties on the time needed to sell out all those units. Overall, our read is that the major players have been prudent in the early part of 2016, which we think is normal and we see it as a sign of conscious risk management. We note that experienced players such as SHKP and Nan Fung started buying land in March 2016 while other experienced players like COLI, K&K etc. have taken advantage of the weak market sentiment to strengthen their Hong Kong landbank.
COLI won the bid for the Tai Po site, at HKD1,848/sq ft	The developers are factoring in a major correction in residential prices	We think it is important to look at the size of the site and its features before passing judgement on the achieved price. This project is large, with a GFA of 1.15m sq ft, and the total lump sum investment was not small – COLI noted that the planned investment is HKD10bn and that this is its largest single investment in Hong Kong so far. We think the execution of this project will require a lot of work because the site is not suitable currently for simple mass-market projects for home starters, where the developer can apply a high-asset turnover model to build standardised products in the shortest amount of time possible. In our opinion, this project will require a lot of work, and COLI will have to market the product as one for the upgraders and the wealthy. Also, COLI has probably factored in that visibility regarding the demand of higher-end products in the New Territories isn't high, and this is likely to remain the case while the government measures are in place.	On the whole, we see this investment as a clear and strong signal that COLI is keen to maintain a meaningful presence in the Hong Kong residential property market. Note that COLI could get access to many landbank opportunities in the Mainland (if it wanted to) and the fact that it is still willing to commit a HKD10bn investment to the Hong Kong residential property sector at this point implies to us that it isn't too bearish on the outlook of the residential property market in the medium to long term and that it probably sees the weak market sentiment as an opportunity to secure a large strategic site at a reasonable land cost.
Wheelock's SAVANNAH in Tseung Kwan O			

Source: Various media reports, Daiwa

Major events in the property market over the past few months and our interpretation of them (continued)

Events	Popular market interpretation	Alternative interpretation	Additional information and remarks
Difficult to find buyers for new launches	Demand has fallen and the developers need to undercut each other to boost sales	We think residential units in Hong Kong are as much investment assets as consumer goods. It is therefore only natural to see their demand fluctuate widely in accordance with market sentiment, just as demand for shares in the stock market contract significantly in times of uncertainty. We do not think we can conclude that end-user demand has been exhausted. Otherwise, it would be hard to explain why since April, a few projects, such as Ultima II, Ocean Wings and Alassio – have achieved rather strong sales performance.	Under the "new normal" created by the various current government measures, we think the slowdown in primary market residential sales is normal. We do not think end-user demand for residential properties in Hong Kong has been depleted. On our estimates, the structure of Hong Kong's residential property stock (see the next section) indicates that over 90% of the households in Hong Kong are living in units below 70 sq m and are often well over 20 years old and it is hard to believe that this is enough to meet the housing aspirations of the majority of the population. We just think the large downpayment requirement, much lowered liquidity, and large cumulative rise in home prices in Hong Kong have made many potential buyers hesitant to commit, especially in times of major market uncertainties. We also think the above developments mean that it would now take much longer for home-owners to acquire sufficient capital to upgrade to a larger unit. That said, we note that Ultima II has sold well recently, but the average price per unit in this project was over HKD35m. Ocean Wings has also sold well, and the most popular units are the 4-bedroom ones which generally cost HKD12m or above. In our view, this implies that for quality units which can offer scarcity value, demand is still there.
		We also think that when assessing the demand for new launches, t the following factors need to be taken into account: 1) Nowadays, demand comes mainly from end-users and many new launches are only delivered to end-users 12-24 months after launch. 2) The announced ASPs of new projects are based on immediate payment, meaning that buyers need to start paying mortgages 12-24 months before they can use the units. 3) Achieved primary market sales in 2014 and 2015 were at all-time highs for the industry and it is likely that some of the buyers purchasing power has been absorbed already. 4) A significant part of HK's residential property demand comes from people looking to upgrade and their ability to monetise the capital gains they have in the units they purchased in the past. A more robust secondary market is needed to allow such demand to be released. 5) With the various government measures in place, the normal upgrading cycle in the residential property market has to lengthen considerably, [if not be almost eliminated, as the required downpayment for larger units has become so high that many end-users may need to give up the idea of purchasing. 6) The main impact of the various government measures is that they have suppressed secondary market transactions and upgrade demand. Under the "new normal", ie, a subdued secondary market, and against a background of strong primary market sales in 2014 and 2015, such primary market sales probably will probably be lower for the foreseeable future.	
SHK Properties' Ultima II in Ho Man Tin			

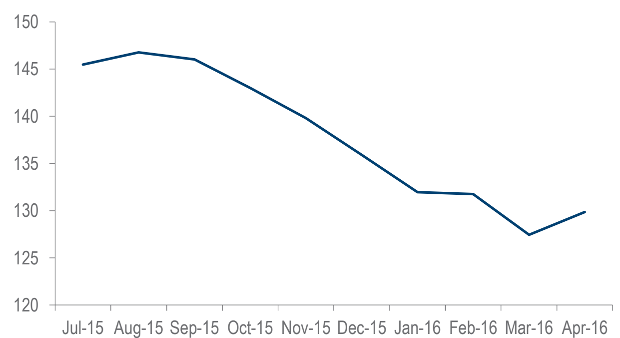
Source: Various media reports, Daiwa

Major events in the property market over the past few months and our interpretation of them (continued)

Events	Popular market interpretation	Alternative interpretation	Additional information and remarks
A number of super-luxury units have been sold at record-breaking or close to record-breaking prices	The media didn't not pay much attention to this	The number of billionaires who want to own super-luxury residential units in Hong Kong appears to still be much larger than the number of suitable units available in the market.	Demand for such types of units is very discretionary and this market often dries up in times when the wealthy perceive that there are great uncertainties and downside risks in the market.
			We expect super-luxury units to be the most resilient segment of the residential property market for the foreseeable future. Historically, when the super-luxury market segment has held up with reasonable volume, the overall market generally does not do too badly.
The 130 units in Manhattan Heights sold out quickly	The media didn't not pay much attention to this	We think this shows that there is latent purchasing power that can pop up quickly when the product and pricing are attractive enough.	Manhattan Heights units were owned by an old well-established HK family (the Ho family) for rental in the Western district of HK Island
			The unit price for these homes wasn't that small (HKD6.2m-14.5m) and the 600 sq ft units were all taken up in a few hours.
SHK Properties' Ultima II project has sold around 200 units	The media attributed it this to price-cutting by developer SHKP	It looks like wealthy end-users are still interested and have confidence in holding HK residential property assets. Unit prices at the Ultima start from about HKD20m with many units at more than HDK30m.	Phase one of the project commanded a large premium versus comparable secondary market units in the district because of SHKP's strategy to market it as the most luxury residential project comparable to those in West Kowloon rather than merely another project in Homantin. SHKP has now brought the prices for phase two of the project back to levels that are more in line with comparable secondary market flats.
			We think that how the wealthy see the prospects for Hong Kong residential properties has a major influence on the outlook for the sector, as they collectively own a significant proportion of Hong Kong's secondary market units. If they do not suddenly look to offload quickly, we think there will be a limit as to the extent the secondary market supply will rise over 2016.
			Historically, luxury residential units tend to stabilise earlier than mass-market ones. We also note that Class C and D units have been holding up notably better than the Class A and B units for the past 6-8 months.
Registered secondary market transactions fell to only 1,658 units for January 2016, more than 40% below the low seen during SARS	No demand for residential units in the market	We say this could also imply limited supply either. Our read is that when the market sentiment started to turn in 2H15, there were keen or desperate sellers that needed to offload their units. Since these units were taken up, there has not yet been a major increase in the number of such units. Market sentiment in Hong Kong seemed to be at its lowest just after the Lunar New Year (in Feb 2016) but our market research suggests that this did not result in a notable increase in the number of units available from desperate sellers. So far this year, we have not seen that many units from desperate sellers willing to sell at almost whatever price and those where prices have been cut have been taken up quickly.	For the sector as a whole, we think flat owners' holding power is strong, with quite a few deciding to lease out their units. And of course, for those flat owners willing to cut prices, these units are being snapped up quickly.

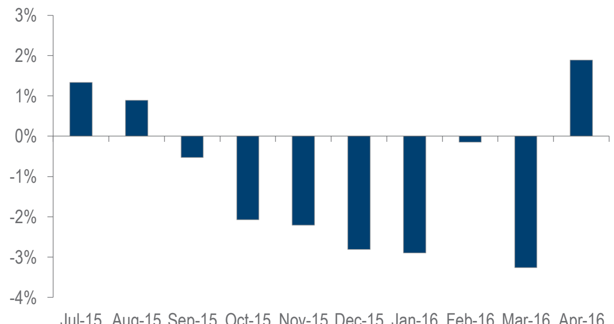
Source: Various media reports, Daiwa

Hong Kong: Centa-City Leading Index since August 2015



Source: Centaline, Daiwa

Hong Kong: MoM change in the Centa-City Leading Index since August 2015



Source: Midland, Daiwa

Retail segment

Major events in the retail property market over the past few months and our interpretation of them

Event	Popular interpretation	Alternative interpretation	Additional information and remarks
Coach decided to close its flagship store in Central	Luxury brands are withdrawing from Hong Kong	Part of the rational adjustment so far and it has not exited Hong Kong, nor has any other major international brand.	Coach still has 17 stores in Hong Kong.
			The rent Coach paid for that flagship store was over 10x the amount paid by Body Shop in 2003.
Hermes decided to offer its Central flagship store for sale by tender	Another luxury brand turning bearish on Hong Kong retail.	We actually see this as a reassuring signal. Hermes is not "closing" its flagship store, it is just relocating to an arguably better retail environment in Prince's Building, which is a few minutes' walk away. Moreover, the size of Hermes' new store in Prince's Building is actually larger. Given the large gain it could make from the sale of the shop (over HKD1.3bn in profit), we think Hermes's decision to offer its store for tender, and to lease rather than own, is rational and backed by sound commercial considerations. We do not see this move as a sign of it downsizing or reducing its commitment to the Hong Kong retail market.	Hermes bought the shop space at No. 9 Queen's Road in 2002 for HKD190m, when it thought it would be cheaper to buy than rent. Now, it has moved to a slightly larger store in Prince's Building and is selling the store on Queen's Road with an asking price of HKD1.5bn.
Various shop spaces previously rented out for watch and jewellery shops are now being leased out at rents that are 20-40% lower	This is a sign showing how bad the retail market is and foretells what could happen to rents for other retail properties.	High-street rents in Hong Kong have overshot significantly in the past and the current situation can be seen as a return to economic reality. Shops on the high street and those in shopping malls represent 2 different segments, with rents for high-street shops, even after the current correct, generally still notably more expensive than those in shopping malls. At their peak, rents for prime high-street shops can be more than HKD2,000/sq ft (gross; the highest on record was over HKD3,000/sq ft) and even if these rents were to fall by 50% or more, they would stil be very high versus the average in shopping malls (the highest is about HKD220/sq ft gross while the cheapest could be below HKD20/sq ft gross).	High-street shops in Hong Kong's main retail hubs account for less than 0.5% of the total retail property space in the city. We think the watch and jewellery retail segments are following a similar trend to what the investment banks did in the office sector over the 2005-10 period. Note that the retail space left behind by the watch/jewellery and luxury brands is still being taken up (eg, Adidas took over the Coach store in Central).
Many suburban malls targeting local consumers are still achieving positive retail sales and rental growth.	The media generally does not pay much attention to this. Some expect them to follow the high-street shops sooner or later in terms of rental trend.	From 2004-10, office rents in Central tripled and the rental gap between offices in Central and other areas rose to an unprecedentedly wide level. Over 2011-13, office rents in Central fell but rents in non-Central areas held up, which could be seen as a rational adjustment to bring the rental gap back to a more normal and sustainable level. We think it is arguable that rents for high street shops and prime retail space in Hong Kong have undergone a similar move as prime offices in Central during 2004-10. As such, we think it is conceivable that a similar thing could happen to the retail sector, with rents and tenant sales for highs street shops in the prime retail spaces correcting but rents and tenant sales in suburban malls still holding up. We do not see why a similar situation could not happen to the retail property sector as well in 2015-17.	Many international brands have come round to the idea of opening stores in the New Territories. The consumption power of the local population is still underpinned by low unemployment, high household savings, and a large increase in their home equity versus 10 years ago.

Source: Various media reports, Daiwa

Office segment

Major events in the office property market over the past few months and our interpretation of them

Events	Popular interpretation	Alternative interpretation	Additional information and remarks
Some investment banks have been downsizing	Grade A offices can't do well if investment banks are not expanding	The investment bank segment has been the main driver of Grade-A office rents, leading to them rising sharply and quickly in the past. But the industry's relative importance to the Hong Kong office sector has been declining for a number of years, to the point where now it does not actually account for a large amount of the office space in Hong Kong (a lot less than 10% of the Grade-A office space in Central, on our estimates).	Many investment banks have already moved their middle or back-offices out of Central and a few have moved their front offices as well. The current less than 3% vacancy rate in Central (even after taking into account potential sub-letting), implies that the space vacated by the investment banks has been filled. The days when investment banks were very important for the Central office market have probably been over for quite some time.
No reported case of a major office expansion by any of the large corporations in HK	Demand for office space in HK is weak	We think the structure of office demand in HK has changed over the past 5-10, with the city having become a more mature office hub. Yes, we have not seen large-scale expansions by multinational corporations in HK over the past few years, but still over 10m sq ft of new office space in Kowloon East has been filled. Also, the vacancy rates for all the major office districts is below 3% and new office districts are emerging. Meanwhile, corporate profit tax paid in Hong Kong reached an all-time high in 2015.	We believe that the moderate expansion of a large number of existing corporations and the continued arrival of new corporations in small/ medium-sized spaces is arguably healthier and more sustainable than demand for just large offices driven by a few large corporations.
WeWork has leased 90,000 sq ft in this building			
Office demand from Mainland firms	Such demand could be temporary and unreal, and could fluctuate significantly in line with the A-share market	We do not think that office demand from the Mainland financial sector is driven entirely by the state of the A-share market. Instead, we think it is related to financial reforms in China and the country's aim to have gradual integration with the rest of the world in the financial sphere as well so as to modernise the country's financial sector. We believe that, other than equities, bonds, commodities, FX, private equity, asset management, insurance, etc, are also important segments of China's financial sector. As long as reforms and new developments continue for these sectors, this should be a stimulus for office demand in HK from both Mainland corporations. Meanwhile, the arrival of more mainland financial institutions to Hong Kong, over time, could also stimulate more local or overseas companies targeting to serve these mainland corporations.	The presence of Mainland corporations in Central, though catching up quickly, is still low versus that of international corporations. According to a study by CBRE, China entities account for 19% of the office space in Central vs. 22% for European companies and 23% for US corporations as at 2014. At the peak of the pre-GFC days, European companies accounted for 29% of the office space in Central.
Major en-bloc purchases of offices by Chinese Mainland companies	Does not reflect genuine office demand	While some of these transactions may not be driven by genuine office demand, we believe that many more such deals will happen and that some of these China companies do have genuine intentions to build and expand their presence in HK.	Many first-tier nationwide corporations in China do not yet have a meaningful presence in Hong Kong, as is the case for the second-tier and provincial level companies, which means that there are still plenty of Chinese corporations which could come to Hong Kong.

Source: Various media reports, Daiwa

In our opinion, if we take all of these events and superimpose them on the development of the sector over the past 30 years or so, we believe the real situation that is unfolding today is more complex, and could well mean that the economic forces the Hong Kong property market has been struggling to come to terms with could see the market being driven up to another level as a metropolitan property market. The initial response to Hong Kong's surge in scale as a metropolitan city was an across-the-board rally in both prices and rents for basically all property asset classes in Hong Kong. This has resulted in stretched prices and rents at the top end segments, even though the lower end segments of the respective sectors have already been quick and creative in terms of positioning themselves as alternatives, which has already had a restraining effect on prices and rents at the top end.

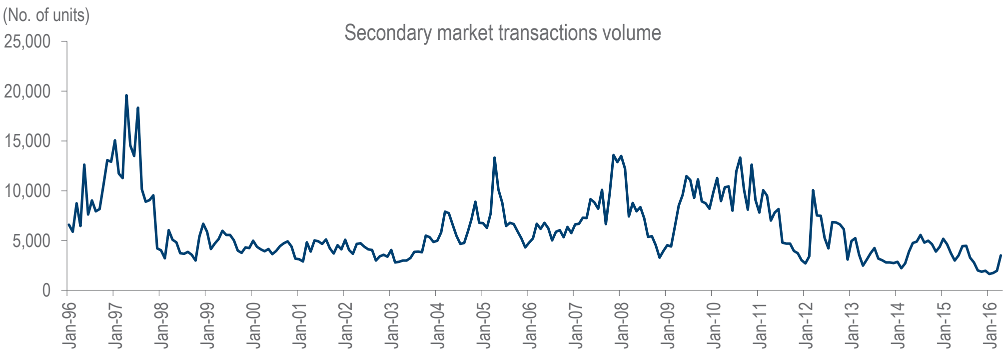
Against this background, some kind of adjustment or pull-back (in terms of both rents and prices at the top end) might provide the overall Hong Kong property sector with a more solid foundation from which to make another leap forward. In this light, instead of the beginning of a meltdown, the correction in prices we have seen so far could represent the "one step back" before "the two steps forward" happens. (We plan to examine this possibility in a separate subsequent report.) We have not seen a sharp plunge in prices and rents and do not believe any of the 3 major property segments is heading towards a gradual meltdown scenario.

Residential segment: in search of a proper level of investment value?

The residential property market appeared to be almost frozen in early 2016 …

Let's start with the residential segment as investors seem to be worrying about this segment the most. Residential prices have indeed been falling since August 2015 and the secondary market was almost frozen up to March 2016 (albeit April saw initial signs that the situation has been turning for the better), with the level of activity in the secondary market (registered transactions in the secondary market of 1,658 for January 2016 and averaging 1,791 for 1Q16) sinking to just over half of the level seen during SARS. Registered transactions in the primary market fell to 233 units for February 2016, leading to some commentators saying that based on those run-rates for February, there would be a huge over-supply of residential units in Hong Kong in 2016, and that developers might need to resort to price wars to boost sales.

Hong Kong: secondary market transactions



Source: Midland, Daiwa

We do not dispute that some of the events over the past 4 months do seem to fit the description of a meltdown scenario, which many had been expecting and which might explain why some media reports have made a big deal out of them. However, on closer examination, we think the real situation is more subtle.

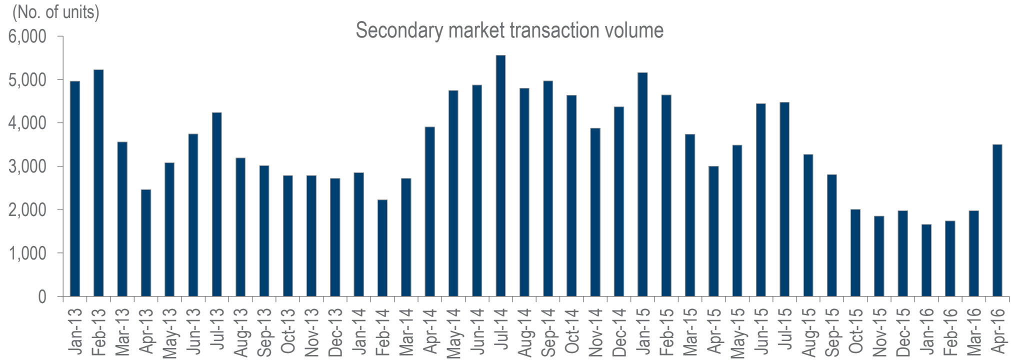
A. Is there really no demand? We don't think so …

No demand? Also not much supply nor many distressed sellers …

We admit that there has been very limited demand in the residential property market since late-2015. However, another interpretation of the record-low transaction volume could be that there haven't been that many distressed sellers either. Arguably, staying put in the face of market uncertainty could be seen as a sign of maturity and prudence, and we think it will take time to determine whether the seeming absence of any noteworthy demand

since late 2015 is really due to no underlying demand or wait-and-see sentiment in the market. Another reason could be that the type of units available for sale and the offered prices are not a good match with what current buyers are waiting for.

Hong Kong: secondary market transactions since 2013



Source: Midland, Daiwa

Either way, our read of the residential property market's developments over the past few months is that the heavily discounted units offered by distressed sellers were taken up quickly. There have not been too many of these types of units, and some have been sold at much lower prices than the current market levels. Yet our observation is that many of these units were taken up before they were available widely to the market. Our market research carried out after the plunge in the stock market post the Lunar New Year 2016 suggests that the number of units offered by distressed sellers has not multiplied as at today.

More importantly, we have been seeing a stream of luxury residential unit transactions. And while there have been some cases of the sellers making a loss, some of them have achieved record or close to record prices. In general, we think the super-luxury end of the market seems to be holding up. We think this is important as historically the luxury segment of the Hong Kong residential property sector has stabilised earlier than the mass market.

Hong Kong: luxury unit transactions since 4Q15

Date	District	Project	Developer(s)	Unit	Net area	Transaction price	
					(sq ft)	Total (HKDm)	Psf (HKD)
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

There seems to be latent purchasing power for the right products at the right price at the right time …

Moreover, we have seen signs of latent purchasing power that can emerge quickly when the market offers something deemed to be attractive enough. A case in point is Manhattan Heights in Western, Hong Kong Island, which was originally meant to be used for rental purposes, but has since been sold off (in late February) by the well-established family that owns them.

While no advertising or promotions were done for this project, all 132 units offered were snapped up within a few days, ranging from HKD6.2m to HKD14.2m, or HKD14,000-21,000/sq ft, which we regard as reasonable versus market levels, but not cheap. We think one reason for the appeal was that there are few similar units available in Western District and this development project has a relatively solid rental market. We estimate that these units offer a gross yield of about 3-4%, which is better than the new units in the market, but not that high, in our view. Still, all the units sold quickly, and the 600 sq ft units were snapped up within a few hours.

Manhattan Heights

Location	Kennedy Town
Developer	Fook Lee Holdings / Cheung Kong
Year of completion	2000
Total number of units	480 (260 strata-titled, 220 serviced apartments held by Fook Lee)
Net sizes	434-699 sq ft
No. of units launched YTD in 2016	~ 132
No. of units sold YTD in 2016	~ 120
Achieved per unit price	~ HKD6.2m - HKD14.5m
Achieved psf price	~ HKD14,000 - HKD21,000

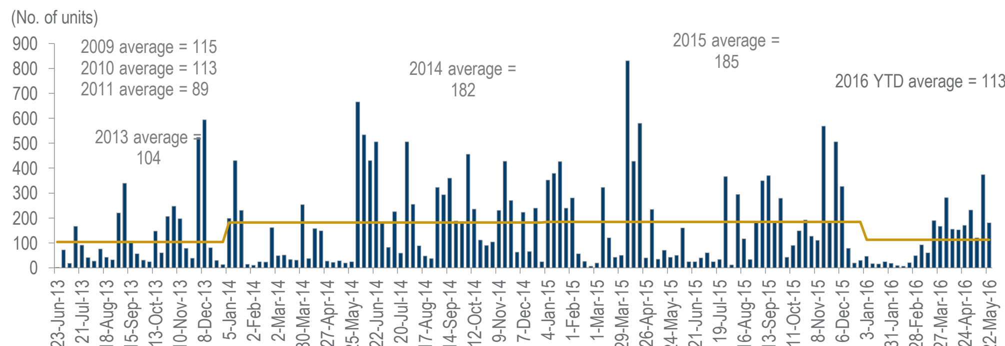
Source: Hong Kong Economic Times, Daiwa

Primary market sales have started to pick up

Similarly, for new projects, we think the low transaction volume in January and most of February 2016 could have been the result of developers also adopting a wait-and-see attitude and not offering many new projects to the market during that period. With this in mind, we are not surprised to see that primary market sales have picked up since late-February 2016, on the back of various launches, such as Yuccie City, Ultima II, Ocean Wings, etc.

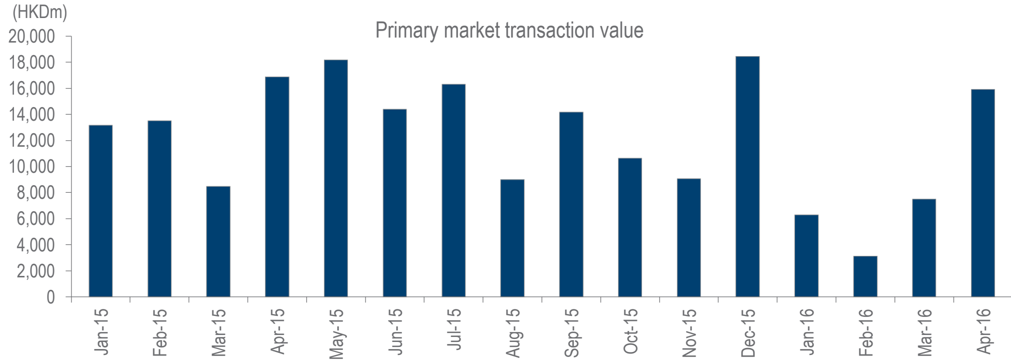
Primary residential property sales rebounded in April

Hong Kong: weekend primary market sales



Source: Hong Kong Economic Times, Apple Daily, Daiwa

Hong Kong: monthly primary market sales in terms of value since January 2015



Source: Midland, Daiwa

Hong Kong: 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	487	455	4.0bn
ALASSIO	Swire Prop	13 Apr	188	181	4.0bn
The Long Beach	Hang Lung	16 Apr	229	227	2.4bn
SAVANNAH	Wheelock	14 May	590	472	2.5bn
Bohemian House	New World Dev	29 Apr	155	137	1.1bn

Source: Companies, Hong Kong Economic Times, Daiwa

Importantly, developments in the physical market in recent weeks suggest to us that quality projects at market prices, together with more flexible and favourable payment terms, such as those offered for the Ultima II, Ocean Wings, have succeeded in stimulating a reasonable level of demand from buyers since early April. We note that the response to the sale of SHKP's Ultima II and Ocean Wings has been good, with SHKP raising HKD12bn in 3-4 weeks. More recently, Swire Properties' Alassio in Mid-levels has also sold well, with

pretty much all the units in the first batch taken up in less than 2 hours, even though the unit price was at least HKD12m. As such, in our view, for quality projects at reasonable prices, demand is still there, notwithstanding all the pessimistic sentiment in the market.

We also think it is worth noting that the physical market's activities in recent weeks seem to suggest that the wealthy in Hong Kong could be gradually returning to the market to look for bargains, suggesting that this time around, their stance is to be net-buyers rather than net-sellers. We note that the average price per unit at Ultima is about HKD35m, while about 50% of the buyers of the first batch of units of Alassio bought 2 units in one-go. Meanwhile, for Ocean Wings, the units in most demand are the 4-bedroom ones, where prices are at least HKD12m. As we have mentioned, the influence of the wealthy people in Hong Kong on the local residential property market has been disproportionately large relative to their absolute number (see our Flash note *Hong Kong Property: Can the interest from the wealthy be sustained?)*

As such, we see these developments as worth noting, as well as initial signs from Centa-City Leading Index that residential property prices started to stabilise in early April. Given that the market seems to have been expecting a vicious price war to erupt with no demand in the market, any continuation in the level of demand seen in March and April has probably already provided some relief in terms of market sentiment.

Is there really going to be a vicious price war?

Of course, it remains to be seen whether the moderate rebound in residential property transactions is just a temporary phenomenon, lasting only a few months. That said, even if market demand dries up after a few weeks, we don't think a vicious price war is on the cards. True, we do expect the next batch of launches to be priced competitively (ie, that they will be priced similarly to newer units in the secondary market), but unlike some market commentators, we don't think this the same as the vicious price cutting that we saw in 4Q97-2Q03, which we consider to be a special situation due to the land market at that time.

B. A significant over-supply in the primary market? We doubt it …

While there is a lot of talk in the market that the forthcoming supply (over 40,000 units) will far outstrip the take-up in the primary market, we think such comments need to be put into context and are likely to have over-stated the real situation. Note that presently, developers can pre-sell up to 30 months before completion. This means that technically, sellable resources from developers could amount to about 2.5 years of annual supply at any particular point. Based on such a supply figure, demand would need to be 2.5x the normal level in order not to create an over-supply situation.

But is this a fair expectation and analysis? Based on figures as at the end of March 2016 from the Housing Bureau, the total number of units to be completed over the next few years is 92,000 units. This is the total number of units for which the developers have paid the land cost and must be completed over the next few years. While it is theoretically possible that they could pre-sell over 40,000 units in the coming year, if developers price to sell out this magnitude of supply, they would more or less sell out all their units on hand in 2-3 years, while the average development cycle in Hong Kong has now lengthened to about 5-6 years.

Based on past experience, developers generally try to phase out pre-sale volume in accordance with the demand situation, which is only a rational commercial decision against the background that they have a substantial stake in the residential property market and that replenishing landbank in Hong Kong has not been easy in recent years, if only because of the entry of new comers from the mainland. Indeed, under the government's new rules governing pre-sales which require a lot more administrative work and preparation, selling hundreds of units in one-go has become much more difficult than before. Note also that over the past 10 years the annual pre-saleable units in the market have always numbered over 30,000 units in any year, but the actual number of units being offered was always much lower. As such, we think the general perception that there would be significant over-supply in the primary market is overplayed.

We would also note that the government measures implemented since 2010 have significantly suppressed secondary market transactions, as the transaction cost involved (mainly stamp duty) for both selling and buying residential units has become very high (amounting easily to 15% or more, up to a maximum level of 23.5%). As such, we think the primary market should remain in a good position to grab market share from the secondary. While the pace of primary market sales has slowed since 2H15, we think it is important to remember that 2014 and 2015 were 2 years of exceptionally strong primary market sales (see below).

Against this background, we think some slowdown in 2016 is to be expected. In the past 20 years, annual primary residential market sales have averaged HKD102bn with the lowest being HKD52.4bn in 2006 (see below). As such, as long as annual primary market sales are over HKD63bn in 2016 (20% above the level seen in the lowest point in 2006), we would consider such a level to be normal and reasonable. We think it would not even be bad if the figure were HKD95bn (the average in 1996-2013).

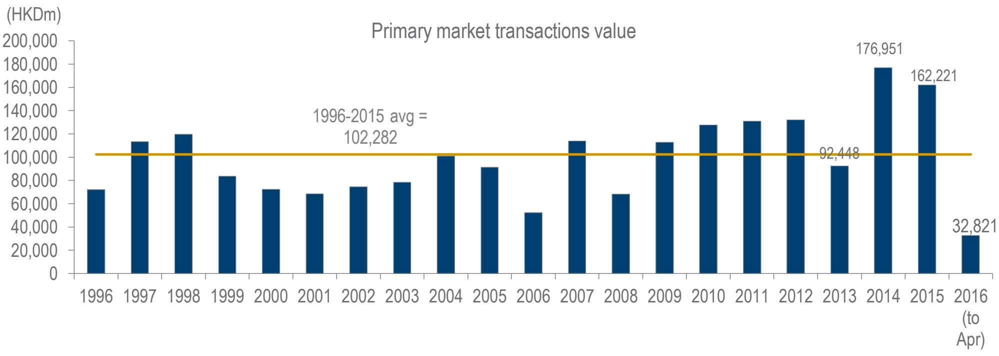
Transaction volumes have rebounded since March

In terms of primary market sales, the registered figures for January and February were very low (HKD6.3bn and HKD3.1bn, respectively; we think no major new launches was one main reason), but March saw an improvement to HKD7.5bn, while for April the figure significantly rebounded to HKD15.9bn in April and HKD16.4bn in May month-to-date. Note that there is about a 1-month time lag for the registered figures in the Land Registry and so the April figure really reflects the market situation in March.

Given the pick-up in primary market sales in April, we would expect the registered figure for May to show even stronger improvement, and estimate the YTD figure will reach HKD50bn by the end of May. As such, if the run-rate in the coming months does not slow down dramatically, it is on track to meet or exceed our current estimate of HKD91.8bn for the full year, which would already be more than half of the annual average figure since 1996 (the first year such figures became available).

In all, we think the actual primary market sales situation is not as bad as some media and commentators have depicted, and we think the popular belief that there is significant over-supply in the primary market – and hence a major price war coming – has been overplayed.

Hong Kong: annual primary market sales in terms of value



Source: Midland, Daiwa

C. Are residential property prices in free fall across the board? It seems not …

Prices of medium and larger units appear to be holding up better than those for small units

Apart from perceiving an absence of demand and significant over-supply in the primary market, another area where the market may have had misconceptions is prices, which it believes have been in free-fall. While it is true that overall residential property prices have been falling since August 2015, we would point out that prices for medium and larger units (ie, Classes C and D) have been relatively resilient since the price correction started in

August 2015, falling by an average of 6.4% and 4.1%, respectively, since August 2015, compared to 15.4% and 14.1% respectively for Class A (below 39.9sq m) and Class B units (40-69.9sq m) units. As such, we do not think the low reported prices for small units is necessarily representative of the sector overall.

In our view, the current situation facing the small Class A and B units is similar to what Central offices faced during 2011-13 and high street shops have faced since 2014 – they have been the areas where rents and prices have been the most inflated relative to other segments and needed to undergo a significant correction to bring the market back to equilibrium.

Another factor to put the residential property price changes since August 2015 into context is that the government measures could have created a kind of “new normal” in the residential property market, whereby transaction volume has become much thinner than before and the range of transacted prices could have become wider than usual. This is because under the “new normal”, when market sentiment is soft, buyers would be more hesitant to commit (due to higher transaction costs, much larger downpayments and more stringent bank lending guidelines), selling becomes more difficult, and this could exaggerate the magnitude of any price declines.

The excesses this time around centre largely on small and old units

Conversely, when market sentiment is good, sellers would be afraid of not being able to buy after selling (due to higher transaction costs, much larger downpayments, and more stringent bank lending guidelines, especially for people who own more than one unit), and this could exaggerate the magnitude of price increases as sellers would ask for more as compensation. We also think this was one of the main factors in the large rise in prices for small and old flats in 2013-15, and we see this as the segment in the residential property market with the largest amount of excesses that need to be cleared through the market process.

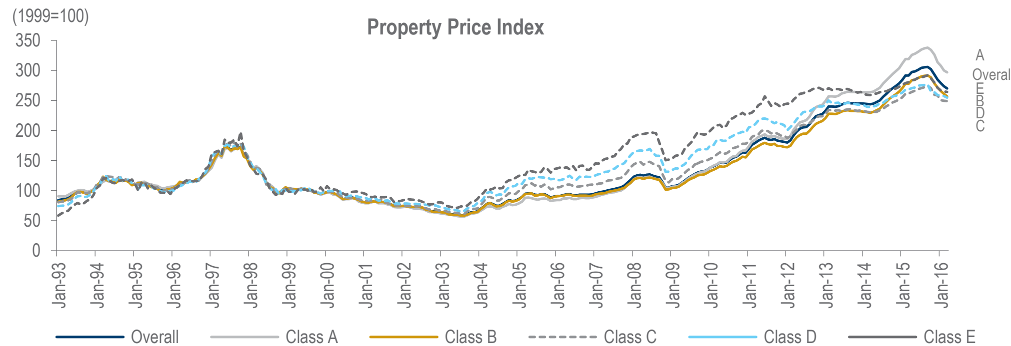
Hong Kong: change in prices for different types of residential units

	Class A	Class B	Class C	Class D	Class E
Change in price (Nov 2010* - Aug 2015*)**					
HK Island	82.1%	61.5%	49.9%	21.9%	29.1%
Kowloon	105.8%	65.7%	16.7%	8.3%	15.1%
New Territories	115.1%	96.4%	67.2%	47.2%	11.1%
Average	**101.0%**	**74.5%**	**44.6%**	**25.8%**	**18.4%**
Change in price (Feb 2013 - Aug 2015)**					
HK Island	18.2%	16.3%	11.6%	4.2%	-0.1%
Kowloon	32.2%	15.4%	-0.8%	-8.1%	14.6%
New Territories	37.8%	29.3%	24.6%	44.3%	8.3%
Average	**29.4%**	**20.3%**	**11.8%**	**13.5%**	**7.6%**
Change in price (Aug 2015 - Feb 2016)					
HK Island	-17.6%	-13.9%	-8.4%	-0.9%	-25.7%
Kowloon	-14.0%	-12.1%	0.8%	3.2%	-13.0%
New Territories	-14.6%	-16.3%	-11.5%	-14.5%	-25.3%
Average	**-15.4%**	**-14.1%**	**-6.4%**	**-4.1%**	**-21.3%**

Source: CEIC, Daiwa
*Note: *Nov 2010: the government introduced its first measures for the residential property sector*
***Feb 2013: the government introduced its most severe measures for the residential property sector*
****Aug 2015: the most recent peak in residential property prices in Hong Kong*

We think the existence of government measures would also mean that the evolution pattern of the Hong Kong residential property market is likely to be different from what the office sector has been undergoing since 2011, and the retail sector has been undergoing since 2014. For both the office and retail property sectors, the segments which have seen the largest price/rent increases were the most expensive segments, ie, Central offices and high street shops. By way of contrast, the equivalence for the residential property sector is the reverse – we think that lies in Class A and Class B residential units which are at the bottom-end segment of the residential market.

Hong Kong: relative price performance of various types of residential units since 1993

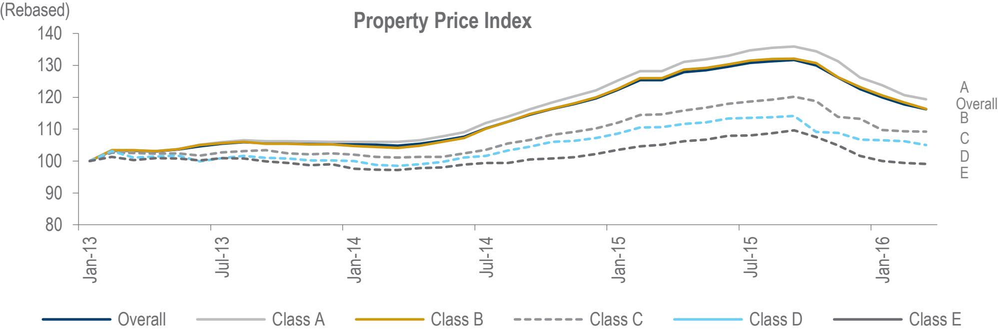


Source: CEIC, Daiwa

Hong Kong: relative price performance of the various types of residential units since 2003

Source: CEIC, Daiwa

Hong Kong: relative price performance of the various types of residential units since 2013

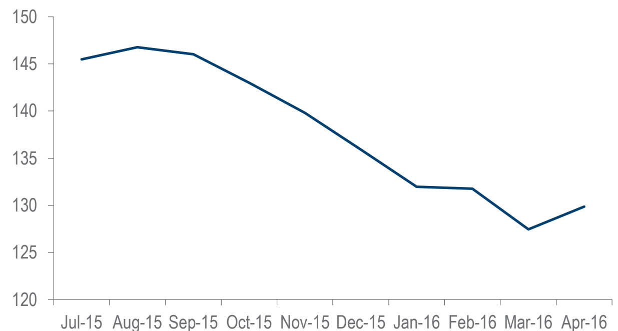


Source: CEIC, Daiwa

Some early signs of stabilization are seen

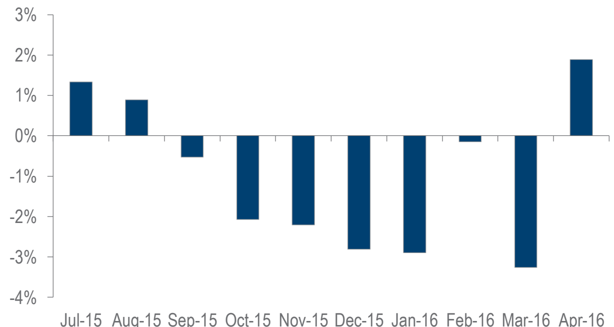
More importantly, with the units from the keen sellers having more or less been fully taken up, we have started to see early signs of a stabilisation in residential property prices, as shown in the Centa-City Leading Index below, which rose by 2% in April, thus narrowing the YTD decline in prices to 4.4%. Our base case assumes that there will be 1 or 2 more rounds of selling from keen sellers and that residential property prices would stabilise only in 2H16 – our base case calls for a 10% decline in residential property prices in 2016. However, if the interest from the wealthy continues, we think it is conceivable that this could bring out pent-up demand from end-users (see our Flash notes *Hong Kong Property: Can the interest from the wealthy be sustained?* of 12 April and *Hong Kong Property: Can more end-user demand come out?* of 14 April). As a result, residential property prices could stabilise earlier than expected, a scenario to which we think the stock market have not assigned any probability.

Hong Kong: Centa-City Leading Index since August 2015



Source: Centaline Daiwa

Hong Kong: MoM change in the Centa-City Leading Index since August 2015



Source: Centaline Daiwa

Hong Kong: change in the Centa-City Leading Index since January 2016

Month	MoM change	YTD change
Jan-16	-3%	-2.9%
Feb-16	0%	-3.0%
Mar-16	-3%	-6.2%
Apr-16	2%	-4.4%

Source: Centaline Daiwa

No. of transactions and average prices in the 10 major secondary residential estates in April

Estate	No. of transactions			ASP (HKD/sq ft, NFA)		
	Apr 2016	Mar 2016	MoM change	Apr 2016	Mar 2016	MoM change
South Horizons	9	11	-18%	13,000	12,100	7.4%
Banyan Garden	8	12	-33%	12,630	11,914	6.0%
Amoy Gardens	12	26	-54%	11,435	10,810	5.8%
Kingswood Villas	38	58	-34%	7,000	6,650	5.3%
City One Shatin	34	25	36%	11,760	11,289	4.2%
Whampoa Garden	12	13	-8%	12,162	11,800	3.1%
Mei Foo Sun Chuen	23	30	-23%	10,044	9,800	2.5%
Taikoo Shing	22	20	10%	14,400	14,200	1.4%
Kornhill	5	13	-62%	12,712	12,542	1.4%
Metro City	18	16	13%	11,286	11,301	-0.1%
	181	**224**	**-19%**			

Source: Hong Kong Economic Times

D. Will forthcoming new supply pose a big threat to the residential market? We are less concerned

Small units make up the bulk of the excess in the residential market

The fact that the main excesses segment lies in its bottom end rather than the top end brings us to one of the major characteristics of the current state of the residential property market in Hong Kong, and this is one of the reasons we are less worried about the residential property market than the rest of the market appears to be. In retrospect, had the free market process been allowed to develop naturally in the current cycle, we would have thought that the residential segment to have accumulated the largest excess would be the top end, similar to what we have seen in the office and retail segments.

In our opinion, the main reason for such a divergence is the government – or more precisely the draconian administrative measures imposed by the government (mostly stamp duties) and the HKMA's loan-to-valuation ratios (LTVs), stress tests, etc., to pre-empt an asset bubble. Our read is that these measures have prevented a lot of capital from flowing into the luxury and 'quasi-luxury' residential segment, as the bar has become a lot higher than before. Instead, a lot of this capital has remained unused, and some investors have opted instead to move into the small-residential unit segment, which has generally been perceived as a safer, less risky and more liquid segment.

It's important to consider the current government measures when putting the prevailing residential situation into perspective

These measures have their pros and cons. The caveat of such government measures, as we read it, is that while they have helped to protect the health of the overall banking industry by limiting the maximum amount buyers can borrow, meaning that only those who can afford a large downpayment can become a mortgage customer of a bank in Hong Kong, they have come at a price, namely sacrificing the living standards of most of the population (such as the normal middle class), making it much harder for people to get onto the housing ladder, which is having social and political consequences for Hong Kong.

However, we think the measures have had some positive consequences on the sustainability of the sector's development. One is that they have prevented the mid-end and high-end residential segments from becoming over-heated, which could have been the case if prices for the top end had continued to rise. The second positive effect, in our view, has been that the social and political issues created by the surge in prices for small units have prompted the government to increase the supply of residential land, which in our view, is exactly what the sector needs.

In our opinion, high residential property prices in Hong Kong could also be seen as the free market's way of saying that it needs more value-for-money alternatives. In this sense, we think the government's attempt to supply more land would help in the long-term development of the industry, just like what Kowloon East office has done to the office sector (explained later in the office section).

Would an increase in government land supply bring down residential property prices? Maybe. But, we think the risk of such a decline in prices is not that high in the Hong Kong context this time as the bulk of the new residential supply should come from the fringe areas in the New Territories. Importantly, our view is that for property, a general rule is that a correction in prices for a certain segment is likely to impact only that segment or those below in terms of price point and relative positioning. As such, if prices for residential units in premier large private housing estates in urban areas were to collapse, this would bring down prices in second-tier housing estates and those with inferior units in urban areas and the New Territories. However, its impact on the residential units in Mid-Levels, etc., would likely be much more contained.

For the same reason, if prices in fringe areas (such as Kingswood Villa in the northwest New Territories) were to collapse, it is conceivable that such a collapse could be a contained localised problem in the area (ie, premier housing estates in urban areas and the high-end units in Mid-Levels, etc., might not be affected that much as depressed prices for Kingswood Villa would be unlikely to result in people moving out of Mid-Levels to live in Kingswood Villa).

Thus, another factor that would help the residential property sector, and one that may not yet have been recognised by the market, is that this time around, the problematic segment seem to be at the bottom end of the market, while a lot of end-user demand for the medium and larger-sized units has been suppressed (but not eliminated) by the draconian government measures that are currently in place. In our opinion, adjustments in the mid-range and higher-end residential segments have been going on since 2013, meaning that the overall Hong Kong market is not as vulnerable as some might think.

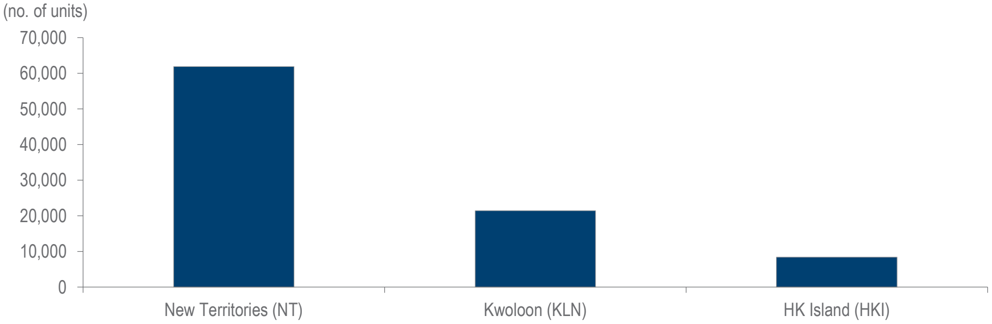
Furthermore, just as the correction of high-street shop rents in prime retail locations since 2014 and central offices over 2011-13 did not develop into an across-the-board phenomenon, we think the overall Hong Kong residential property sector could well be more resilient than Class A and B segments, and that the problems we are seeing in the overall residential property sector could be more localised than they appear.

Impact from the future residential supply likely to be milder than in 1998-2003

Another point to consider is that the type of new supply to emerge in the next few years is likely to have much less 'destructive power' compared to the new supply that was launched after 4Q97. As we mentioned above, one general rule in property, in our view, is that the correction of prices in certain segments is likely to impact only those segments or those offering cheaper units. In this light, one problem relating to the supply after 4Q97 was that many of the units available for sale in 1998-2003 were in premier housing estates along railway lines. This is because one major source of land supply before 1997 comprised sites along the Airport Expressway and these were considered premier units in the market. Hence, when the prices of these units had to be slashed in order to sell during the 1998-2003 period, this had a significant dampening effect on prices of average units in the market.

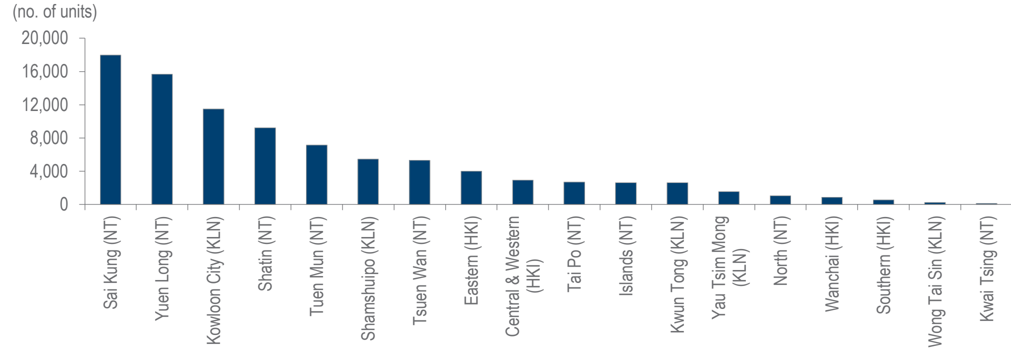
In contrast, the main source of land supply over the past few years, as well as in the coming years, is in the New Territories, and the new supply of units has been and will be shared by various districts such as Yuen Long, Tai Po, Lantau, Tsuen Wan and Tseung Kwan O. This is another factor that has led us to think that even if we do see an over-supply of residential units going forward, it is more likely to be a localised and a district-specific problem.

Hong Kong: distribution of new residential units supply in 2016-20E



Source: Midland, Daiwa forecasts

Hong Kong: distribution of new residential unit supply in 2016-20E (18 districts)



Source: Midland, Daiwa forecasts

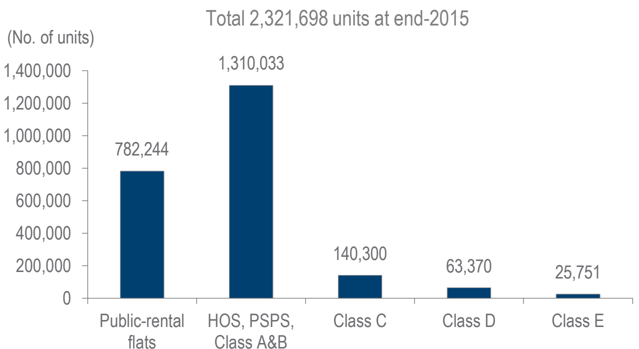
E. Can Hong Kong residential properties sustain their investment value? We think so …

What is the proper investment value for Hong Kong residential units?

From the broadest perspective, we think Hong Kong's residential prices can be seen as a phenomenon where the free market has been struggling to establish a proper and sustainable investment value for a consumer good that has "suffered" from decades of cumulative under-supply. Overlaying this is the rapid expansion in wealth and incomes among the top end of Hong Kong's population. As a consequence, our observation is that while residential units were largely considered consumer goods in Hong Kong in the mid-1980s, prices began to reflect an increasing proportion of investment value from the late-1980s, a situation which has been reinforced by the negative real interest rate situation that started in the late 1980s.

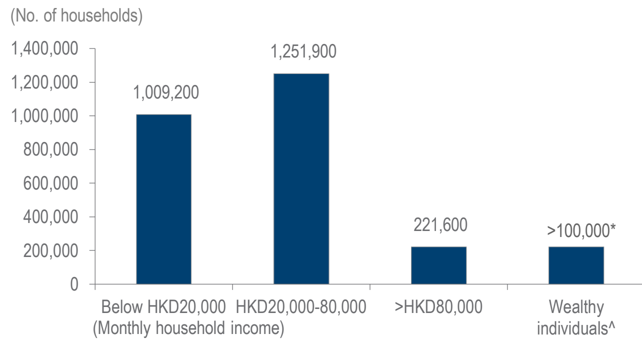
Due to the complexity of the issue, we plan to deal with it in our next report. Suffice to say, we think the perceived investment value of Hong Kong's residential units is still well-supported by the fact that many legitimate and sustainable end-users have not yet been satisfied as a result of the existing housing stock. While such investment value would, and should, fluctuate widely, our view is that it should remain present, meaning that residential units in Hong Kong would always command a value above their value as a consumer good, before the structure and scale of residential property stock in Hong Kong evolves to a point where at least most of the housing aspirations of the middle class have been met.

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)

Thus, we think that structurally, the Hong Kong residential property market is still in an under-supply situation, in that a large part of the local population is still unfulfilled, in terms of their housing aspirations. And we think the existence of unsatisfied end-user demand means that there should be support for demand once prices have 'corrected enough'.

Hong Kong: structure of residential stock in terms of unit size and price

Private housing stocks (no. of units) – end-2015	Class A	Class B	Class C	Class D	Class E	Total
HK Island	105,998	137,159	38,791	27,007	15,952	324,907
Kowloon	127,339	166,228	41,226	17,607	2,922	355,322
New Territories	122,632	256,677	60,283	18,756	6,877	465,225
Total	**355,969**	**560,064**	**140,300**	**63,370**	**25,751**	**1,145,454**
Private housing price (HKD/sq ft) – Mar 2016	**Class A**	**Class B**	**Class C**	**Class D**	**Class E**	
HK Island	12,070	12,705	14,697	17,454	20,028	
Kowloon	9,695	10,276	13,604	14,664	17,844	
New Territories	8,894	7,871	8,649	8,523	6,630	
Private housing price (HKDm/unit) – Mar 2016	**Class A**	**Class B**	**Class C**	**Class D**	**Class E**	
HK Island	4.3	8.4	14.9	27.1	43.1	
Kowloon	3.5	6.8	13.8	22.8	38.4	
New Territories	3.2	5.2	8.8	13.3	14.3	

Source: CEIC, Daiwa

The psychological barriers in Hong Kong will have to be broken eventually

While Hong Kong's residential property prices are undoubtedly high compared with other cities, we think this situation exists for a reason. We see the high residential property prices in Hong Kong as a transitory phenomenon created as a result of the fact that the increase in residential units in Hong Kong has not been able to catch up with the rise in wealth and the number of middle class in Hong Kong. As and when the supply of units in the mid-range (say USD0.5-1m per unit) increases in Hong Kong, we would expect the median prices for residential units in Hong Kong to gradually converge with the norm in major international cities. However, we think the Hong Kong population will eventually need to accept that it is normal to commute to work, as is the case in other international cities, where a 60-90 minute commute is considered normal and reasonable. Such psychological barriers have stuck in Hong Kong, but we believe the economic forces dictate that they would have to be eventually broken.

For example, in the office market, the psychological barrier relating to relocating across the harbour has persisted for decades, but this was eventually broken in 2008 by the International Commerce Centre (ICC), when 3 major investment banks signed deals to move their headquarters across the harbour. In the same way, we think the psychological barrier relating to living in suburban areas will eventually be broken, although this may require more quality units to be available in those areas.

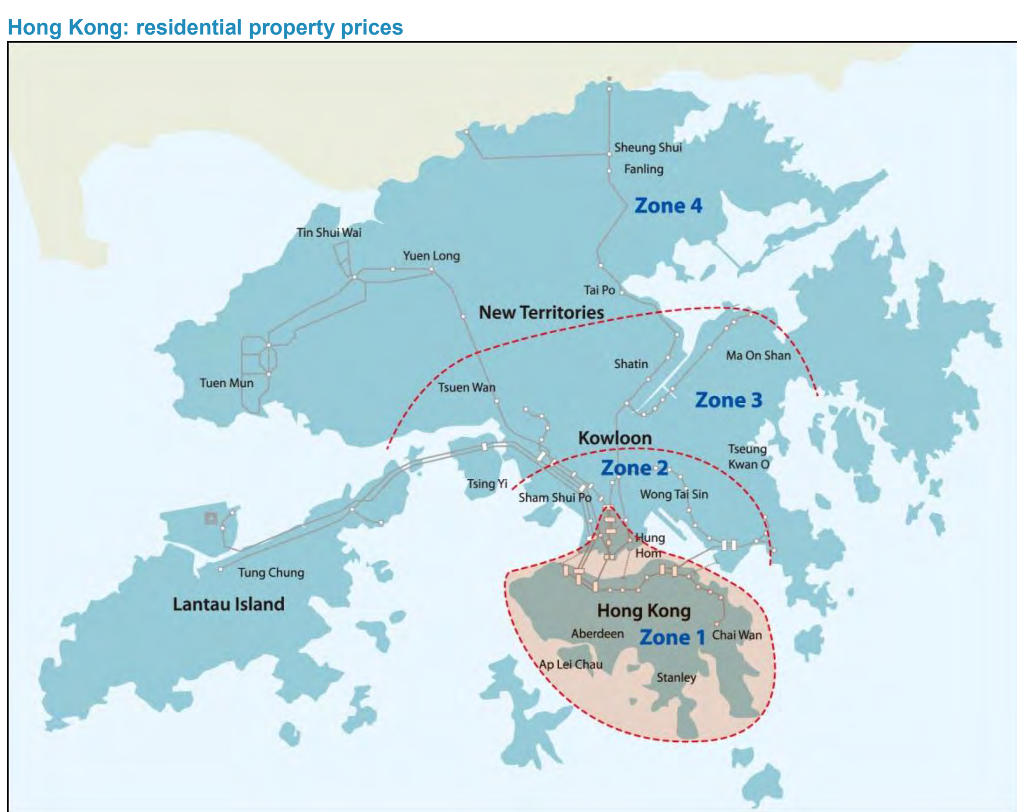
Is an across-the-board fall in flat prices the only way for the market to adjust?

However, we do believe this is the way of the future. And when Hong Kong can offer a larger pool of mid-range middle-class units in suburban areas (unit price of USD0.5-1m), we would expect the unit price for a median unit in the Hong Kong residential property market to become broadly similar to the major metropolitan cities across the world (though size-wise, it would probably still be notably smaller).

This, however, may not necessarily mean that Hong Kong residential property prices would definitely fall. The expensive units in Hong Kong could remain just as expensive as they are now if the number of wealthy and high income households in Hong Kong keeps on rising. The main change could be just that the market would have a lot more new units in the mid-range prices and with more such units being available, the price for a median unit in Hong Kong will likely be lower than it is now; although the location of a median unit in Hong Kong may need to continue to move away from the city centre over time, which has also been the situation in the development of the major metropolitan cities in the world.

Note that under such scenario, while the price for a median unit in Hong Kong is likely to fall, the prices of the existing individual units may not necessarily decline. Meanwhile, the total 'market capitalisation' of the Hong Kong residential property market and the total number of residential units in the market could significantly increase vs. its current level. To the property developers, this might not be such a bad scenario.

Hong Kong: residential property prices



Source: Daiwa
Note: Zone 1: Already seeing "Manhattan prices"
Zone 2: Likely to see "Manhattan prices"
Zone 3: Some projects may be able to achieve "Manhattan prices"
Zone 4: "Rest of HK prices" although selected projects could command significant premiums versus those in the vicinity

We think the current level of residential property prices in Hong Kong is a reflection of the current situation, whereby the types of residential units for which there is the greatest end-user demand are not being created, and the government's regulations have resulted in many end-users not being able to buy the units they desire. Instead, some of the units that would normally have been purchased by the middle class and professionals, have been falling into the hands of the wealthy, who are holding them until the incomes and wealth of the target end-users allow them to buy.

We believe that there is strong demand from the Hong Kong middle class for larger and higher-quality housing, but the current applicable stock available in the market is priced at levels higher than what 'normal' buyers can comfortably afford. This suggests that the transaction volume in the market will likely remain more restrained than usual and that consumer satisfaction is low. Despite this though, we see these types of residential property markets are generally more resilient than they appear, with residential units still offering investment value.

In the broadest sense, Hong Kong residential property prices now seem to be adjusting after overshooting in recent years, especially for Class A (below 39.9 sq m) and Class B units (40-69.9 sq m). However, we still think the demand is there, as there is still a sizeable number of end-users who have not fulfilled their housing aspirations, thus protecting the market from a meltdown scenario.

In short, we think Hong Kong residential property prices are simply adjusting, correcting, or even normalising, but that this had not yet been reflected in share prices in February 2016. Since then, however, share prices seem to be reflecting that the market has begun to accept that an imminent meltdown in Hong Kong property prices is not likely to happen; but based on the current valuation of property stocks, we think there is still significant pessimism in the market and the possibility of the above less-pessimistic scenarios probably have not yet been priced in (for further details, see section 4 of this report).

Retail: will Hong Kong return to a 7m people retail market, or will it still try moving ahead as an international retail hub?

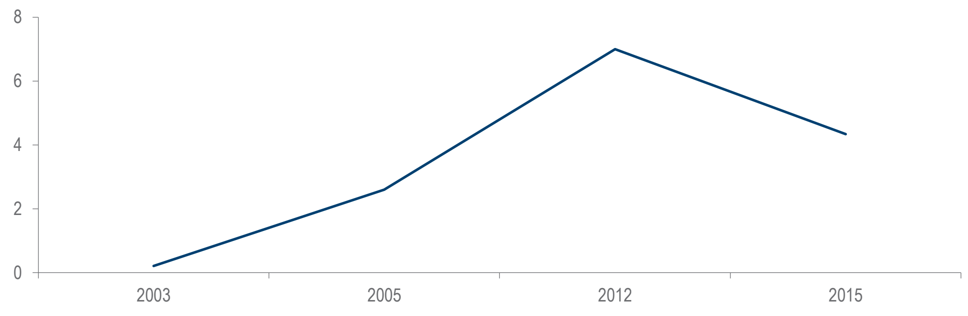
A. Did Coach's closure of its Central flagship store signal the end of the world for luxury retail? The truth is more subtle and complex …

The Coach deal was a highly publicised one

In the tables below, we show the rent paid for the 13,000sq ft store (GFA) on Queen's Road, Central, previously occupied by Body Shop from 1998-2003, then Coach from 2003-15 as its flagship store, and which has now been taken up by Adidas. In our opinion, this example provides a vivid way to illustrate what has been happening, as well as what may happen, in the Hong Kong retail property market.

36 Queen's Road Central: changes in achieved rents and tenant profiles for high-street stores

Year of lease	Tenant	Monthly rent (HKDm)	(HKD/sq ft)	
2003	Body Shop	0.21	53	Ground floor only, 4,000sq ft
2005	Coach	2.6	200	G/F plus 2 more floors, totalling 13,000sq ft Including HKD0.6m for the facade
2012	Coach	7.0	538	The lease will expire in 2017
2015	Adidas	4.34	334	The lease will expire in 2020



Source: Hong Kong Economic Times, Next Magazine, Daiwa

The situation is more complex upon closer inspection

A striking feature of this example is that it represents the magnitude of surge in rents some retail areas in Hong Kong have experienced. Rents have risen 10-fold in 10 years (from 2003-12), significant by any measure, and we doubt there is a precedent in the global retail property market that could surpass or match this. Moreover, Central is arguably not the most important retail property area in Hong Kong; in our view, there are only 3 well-established retail hubs in Hong Kong, namely, Tsimshatsui, Causeway Bay and Mongkok.

In our opinion, Central has only been a niche retail property market in Hong Kong in the past, as it has not been a vibrant enough retail market at night and at weekends in the past. While the area has been gradually transforming, our read is that, as of now, it is still only half-way between a niche retail market and very well-established retail hub.

So what does this deal tell us? Generally, the media has been reporting that this rental situation heralds the doom of luxury retailing in Hong Kong, and that there lies a magnitude of rental corrections ahead for retail properties in the territory. But is this the complete picture? We don't think so. Or at least, we think the message of this deal (the property at 36 Queen's Road Central) and others is more subtle and complex than might first appear.

First, we think it is contentious as to whether Coach is representative of luxury retail. As such, one interpretation of the rent paid by Coach in 2012 could be just what a brand was willing to pay to make a statement securing its image as a luxury brand with major ambitions in Hong Kong's retail market. Note also that the Hing Wai Building (the name of the building at 36 Queen's Road Central) was not the most prime retail address in Hong Kong in 2012, and in fact we do not think Central was a proven retail hub in Hong Kong at that time. This property was and still is owned by a well-established local family rather than one of the major retail landlords, and the retailers in the same building are not established luxury brands.

That said, we think it is understandable that Coach chose this property given the scarcity of retail space in Hong Kong suitable for a flagship store, and that the most attractive addresses for flagship stores in Canton Road, Russell Street, etc., had already been secured by tier-1 luxury retail brands such as Louis Vuitton, Chanel, etc. In this sense, we could assume that for the Coach leasing deal, there were some marketing elements involved. To the extent that the per-square-foot sales productivity of Coach products is lower than that for Hermes, Louis Vuitton or Chanel, and that Queen's Road Central is not as productive as Canton Road or Russell Street, one could say that it was only matter of time before such a lease would be terminated.

We think Coach is rationalising, not exiting – and now there is Adidas …

This, however, also brings us to another point. For the entire negative message associated with this leasing deal, Coach is not trying to leave the Hong Kong market, in our view. Granted, Coach has closed this flagship store, but it still has 17 stores in Hong Kong. In this light, this Coach deal may be seen as more a case of Coach optimising and rationalising its presence in the Hong Kong retail market than exiting.

What is more, the retail space left behind by Coach has been taken up by Adidas, where it has located its Hong Kong flagship store. In our opinion, no major retail property market in the world can be supported merely by luxury brands which are limited in number. In this light, we believe the longer-term prospects and potential of a retail property market always have to be underpinned by a strong and sustaining mid-end segment as well.

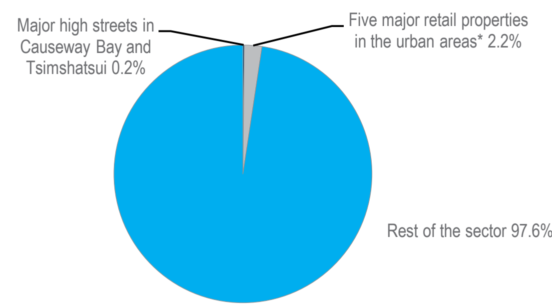
As such, the interpretation of this Coach episode may be more subtle and complex than just luxury brands abandoning Hong Kong. First, we think the deal indicates that there are mid-end retailers willing to lease retail space in Hong Kong despite the poor market sentiment. Moreover, the rent Adidas is paying is not low from a historical perspective and by global standards. In short, for all the pessimism and negative sentiment toward Hong Kong retail property, the vacancy levels for high-street shops are not yet concerning and there still seem to be retailers willing to pay high rent for quality space. Moreover, this situation is not limited to the Coach deal in Central. In several other major retail leasing deals, we have discerned a similar situation, albeit not as well-publicised as the Coach one.

B. Are high-street shops representative of Hong Kong retail property overall? It seems not …

A distinction also needs to be made between high street shops and malls

Importantly, in analysing the Hong Kong retail property market, we think it is important to distinguish between high street shops and major shopping malls. Under the structure of Hong Kong's retail property space, high street shops in Causeway Bay and Tsimshatsui account for only a small portion of the Hong Kong's retail property space, while retail space under the management of well-reputed landlords is also not that large.

Hong Kong: structure of retail property sector



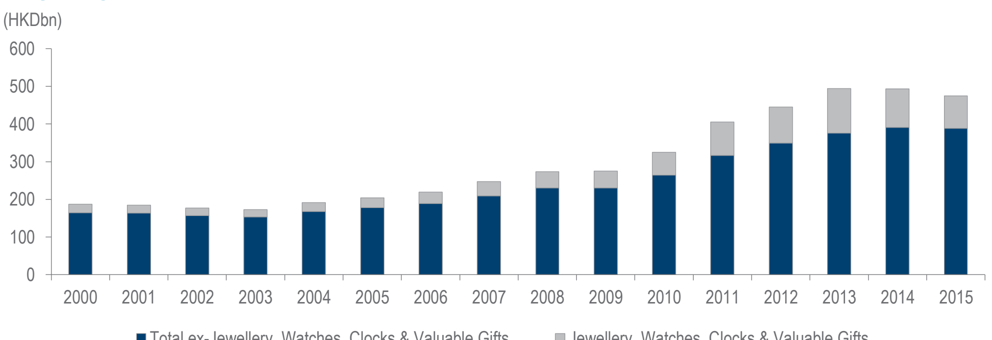
Source: Hong Kong Property Review, Companies, Daiwa estimates
*Note: *Harbour City, Times Square, Sogo HK, IFC, Pacific Place mall*

In any case, our read is that while many high street shops have been hit hard over the past 2 years, malls under major landlords have not been hit as hard; and suburban malls targeting mainly local consumption are still showing retail sales growth, albeit at a slower pace than before. In all, we think the situation is more subtle and complex than the general market perceives it to be, and we do not see the market heading for a meltdown.

High-end luxury sales have a distorting effect on the retail sales figures in Hong Kong

Shown in the table below is a breakdown of retail sales in Hong Kong, which we have broken down into retail sales including watches and jewellery and retail sales ex-watches and jewellery. As we see it, watches and jewellery and luxury brands (government data does not break down luxury retail brands) are the trades that have distorted the retail sales picture in Hong Kong, with watches and jewellery at one point accounting for about one third of all the retail sales in the territory – a situation that we think is unseen anywhere in the world.

Hong Kong: retail sales



Source: CEIC, Daiwa

Hong Kong: retail sales breakdown

	Retail sales (HKDbn)			YoY change (HKDbn)			YoY change (%)		
	Ex-Jewellery, Watches, Clocks & Valuable Gifts	Jewellery, Watches, Clocks & Valuable Gifts	Total	Ex-Jewellery, Watches, Clocks & Valuable Gifts	Jewellery, Watches, Clocks & Valuable Gifts	Total	Ex-Jewellery, Watches, Clocks & Valuable Gifts	Jewellery, Watches, Clocks & Valuable Gifts	Total
2000	164.0	22.7	186.7						
2001	163.2	21.2	184.4	(0.8)	(1.5)	(2.3)	-0.5%	-6.8%	-1.2%
2002	156.5	20.3	176.9	(6.7)	(0.9)	(7.5)	-4.1%	-4.1%	-4.1%
2003	153.1	19.7	172.9	(3.4)	(0.6)	(4.0)	-2.2%	-2.9%	-2.3%
2004	167.3	24.3	191.5	14.1	4.5	18.7	9.2%	23.0%	10.8%
2005	178.1	26.3	204.4	10.8	2.0	12.8	6.5%	8.3%	6.7%
2006	188.7	30.3	219.0	10.6	4.0	14.6	6.0%	15.2%	7.2%
2007	209.3	37.7	247.0	20.6	7.4	28.0	10.9%	24.5%	12.8%
2008	230.5	42.7	273.1	21.2	5.0	26.1	10.1%	13.2%	10.6%
2009	229.9	44.8	274.7	(0.5)	2.1	1.6	-0.2%	5.0%	0.6%
2010	264.0	61.0	325.0	34.1	16.2	50.2	14.8%	36.1%	18.3%
2011	316.4	89.4	405.7	52.4	28.4	80.8	19.8%	46.6%	24.9%
2012	349.3	96.2	445.5	32.9	6.9	39.8	10.4%	7.7%	9.8%
2013	376.1	118.3	494.4	26.9	22.1	49.0	7.7%	22.9%	11.0%
2014	391.1	102.1	493.2	15.0	(16.2)	(1.2)	4.0%	-13.7%	-0.2%
2015	388.9	86.2	475.2	(2.2)	(15.9)	(18.1)	-0.6%	-15.6%	-3.7%
1Q16	96.6	18.6	115.2	(10.8)	(5.6)	(16.4)	-10.0%	-23.2%	-12.5%

Source: CEIC, Daiwa

Against this background, a pull-back in watches and jewellery sales at some point appears to be a phenomenon that was expected, and because of its weighting in the Hong Kong retail sales, would be bound to have a major impact on overall retail sales. That said, Hong Kong retail sales comprise more than watch and jewellery retailers, which actually tend to rent retail space in high street shops than malls. As such, the impact related to the closure of some watches and jewellery stores in Hong Kong over the past two years could be far larger for high street shops than Hong Kong overall retail – total prime retail space in Causeway Bay and Tsimshatsui accounts for less than 0.5% of Hong Kong's total retail spaces, we estimate.

C. Is there really no demand for Hong Kong retail property? We do not think so …

Moreover, for all the pessimism towards the Hong Kong retail property sector, we think the 3 following points are to be noted.

So far, no major brands have chosen to exit Hong Kong ...

First, while some luxury brands are reducing their store count, so far none has pulled out of Hong Kong altogether. Indeed, although the media interpreted Hermes putting its flagship store up for tender as a sign of a major luxury brand trying to exit Hong Kong retail, the full picture is that Hermes is relocating to a new – and bigger – store in the Prince's Building in Hongkong Land's Landmark portfolio, a few minutes' walk from its flagship store.

By way of background, Hermes bought the shop space back in 2002 for HKD190m, when it found it is cheaper to buy than to rent and now it is offering to sell it for HKD1.5bn. We think it is possible that its decision is motivated by a desire to lock in the high return it has achieved with this investment, which is not part of its core businesses anyway. Moreover, the gain Hermes has made is also an indication of how much prices and rents for prime high street shops in Hong Kong have gone up. While the 30-50% decline in rents looks worrisome, the truth is that rents for these spaces have come off from a base which is multiple times the levels seen 10-12 years ago.

Hermes store for sale

Building	The Galleria, Nine Queen's Road Central
Address	9 Queen's Road, Central
Owner	Strata-titled
Shop unit	Unit on G/F with basement
Total area	7,500 sq ft
Rent	HKD4.0m (est'd)
Indicative price	HKD1.5bn (HKD200,000/sq ft)
	Hermes acquired the space in 2002 for HKD190m

Source: Hong Kong Economic Times, Apple Daily

New Hermes flagship store in Prince's Building

Building	Prince's Building
Address	10 Chater Road, Central
Owner	Hongkong Land
Shop unit	Unit on G/F & 1/F shops currently occupies by Brooks Brothers & Dunhill
Total area	9,000 sq ft
Rent	HKD4.0m/month (HKD450/sq ft)
	11% increase from combined rent paid by Brooks Brothers & Dunhill

Source: Hong Kong Economic Times, Apple Daily

The same may be true of Coach's store. When Coach decided to close down its store, the rent it had been paying was over 10x the level 12 years ago. It could be said that Coach's decision to commit to such rent in 2012 might not be a sound commercial decision in the first place, and in this light, one may say that the closure of this Coach flagship store reflects that economic reality is coming back. We still see excesses in the Hong Kong retail property sector, but they seems to be concentrated mainly in the high-street shops in prime retail areas such as Causeway Bay and Tsimshatsui, in ways probably not dissimilar to the situation for Grade-A office rents in Central during 2005-11 when high per-square-foot rents were concentrated in a handful of Grade-A office buildings in Central.

… while others are moving in to take up the space

Moreover, the Coach store case brings us to the second major point about Hong Kong retail property sector. While luxury brands and watch and jewellery retailers have downsized, the space they occupied has not been left vacant for long. Case in point, Coach's space was taken up by Adidas (which has reached an agreement with Coach and the landlord whereby Coach can leave before the lease expires in 2017), and we have seen space previously occupied by luxury brands being taken up by cosmetics and other retailers. Rents may have adjusted but the stores are still occupied, suggesting that there are retailers who are at least willing to try to make profits from retail space. Note also that even after a large decline in rents, the absolute level of rents for these stores is still not low on a global basis.

Hong Kong: major replacements of watches & jewellery/luxury fashion brand retail tenants

Date	District	Address	Shop	Total area (sq ft)	Old tenant	New tenant
Feb 2016	Central	Prince's Building, Chater Rd	G/F - 1/F	9,000	Brooks Brothers / Dunhill	Hermes
Jan 2016	Causeway Bay	Soundwill Plaza, Russell St	G/F	856	Swarovski	Watch/jewellery retailer
Jan 2016	Central	New World Tower, Queen's Rd C	G/F with B/F	13,800	Emperor W&J	Leather goods retailer
Dec 2015	Mongkok	Sai Yeung Choi St South	G/F	870	Milan Station	CSL1010
Dec 2015	Tsimshatsui	Haiphong Rd	G/F	1,400	Chow Tai Fook	TBC
Dec 2015	Causeway Bay	76 Percival St	G/F	500	RADO	Follie Follie
Nov 2015	Central	AON China Building, Queen's Rd C	G/F	1,654	Baldinini	Blancpain
Sep 2015	Causeway Bay	8 Russell St	G/F	3,068	Emperor W&J (Cartier)	Bonjour
Sep 2015	Causeway Bay	Hang Lung Centre, Paterson St	G/F - 1/F	14,000	HSBC	Adidas
Sep 2015	Causeway Bay	60 Russell St	G/F	1,000	Prince W & J	A pharmacy
Aug 2015	Central	Hing Wai Building, Queens Rd C	G/F - 3/F	16,300	Coach	Adidas
Aug 2015	Mongkok	648-652 Nathan Rd	G/F - 2/F	4,194	Luk Fook Jewellery	Lao Feng Xiang
Jul 2015	Mongkok	67-69 Argyle St	G/F	2,050	Crocodile	Lao Feng Xiang

Source: Hong Kong Economic Times, Apple Daily

Is it just a case of returning to normal economic reality?

To put things into perspective, the Hong Kong retail property market has seen over 10 years of robust retail-sales growth, a situation heretofore unseen in Hong Kong, and probably in many parts of the world. In hindsight, Hong Kong has been the first market to benefit from the significant increase in retail consumption power of Mainland China and it has benefited from this phenomenon for over 10 years. Against this background, it is arguably natural that some of the mainland consumption has now gone to other centres, such as Tokyo, Seoul, Taipei, as well as London, Paris, New York. In this sense, what is happening could be a natural evolution rather than a total unwinding of the trend.

We could say that Hong Kong has been the first retail market outside China to ride on the surge of Chinese consumption over the past 10 years. Against this background, it would seem logical that the overall pie of Chinese retail consumption would be shared by many more cities over time. In the broadest sense, Hong Kong has evolved from a 7m-people retail market to a premier market for accessing Chinese consumers. In our opinion, while Hong Kong is now having to share the pie with other cities, China's consumer market will no doubt occupy an important position in the global consumer market, and is growing, so Hong Kong has a fair chance of getting an important share of this pie.

Is Hong Kong's retail sector returning to a 7m-people market? We think not …

Meanwhile, the third point we would highlight is that we believe the boom in retail spending in Hong Kong has brought critical mass to the Hong Kong retail market and elevated the position of the city in the eyes of the global retailer. This is unlikely to vanish soon and we think theoretically, there is no reason Hong Kong cannot move forward as a retail market serving not only mainland visitors but also locals, as well as many Asian and foreign visitors as well; although it remains to be seen whether the landlords and retailers in the city have the will, vision, or creativity to move forward in that direction.

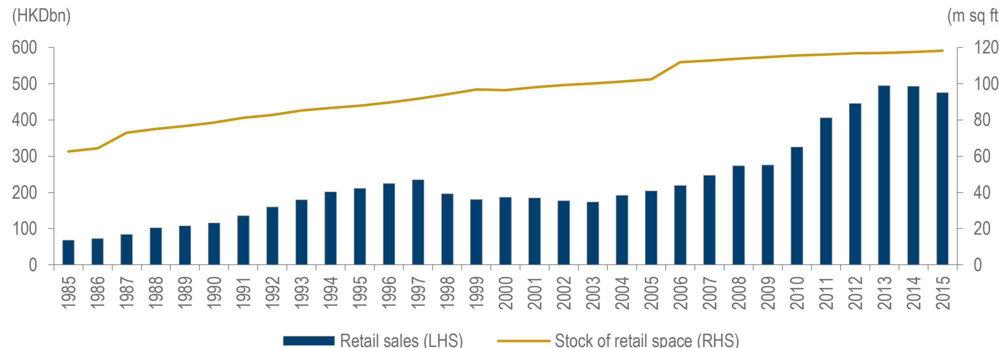
In any case, we do not think Hong Kong will return to a 7m-people retail market and expect the status of Hong Kong as a retail hub to be higher going forward than it was in 2H03 or before. We also see many factors that should ensure Hong Kong gets a share of the Chinese consumer pie, along with a share of consumer spending by Asians and potentially other parts of the world.

In our opinion, one key challenge faced by the Hong Kong retail property sector is the existence of some unreal consumer spending (characterised by a small number of 'shoppers' outlaying exceptionally large amounts of money to purchase big ticket items that they were not buying for private consumption) in China and the pace at which Chinese consumption has risen has had a disproportionate impact on Hong Kong retail property rents and distorted the retail landscape in the territory as it encouraged some watch and jewellery retailers to rent prime space regardless of the level of rent, as they would only have to make a few transactions to pay their rent bill. The result: too many watch and jewellery stores in the major high streets in Hong Kong and some luxury brands having more stores and larger spaces than they require.

However, we do not think the retail property market as a whole has been euphoric about this. We have seen excesses on the high streets (one main hallmark being the high-street landlords' over-reliance on watches and jewellery), but we think the impact of these excesses on the malls vary and there are still a number of malls which have not changed to target mainly the big spenders from Mainland China. Indeed, we see the geographical expansion of the 3 retail hubs in Hong Kong, the rise of Central as another retail hub, the growing strength of the suburban malls, etc., as the market's way of tempering the excesses created by the surge in mainland spending over the past 10 years.

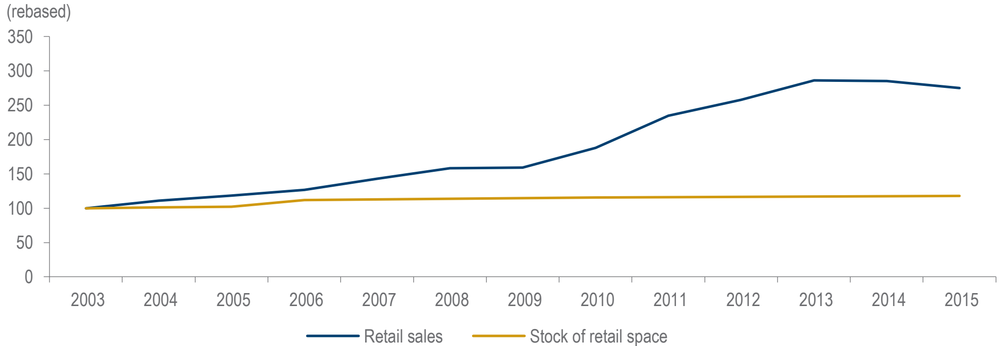
In this light, we think one alternative interpretation is to see the Hong Kong retail property market as being in a process of establishing a balance, and we think it is too early to say that everything will unwind back to the situation 10 years ago. Another point is that the amount of retail space in Hong Kong has not increased that much since 2003, while total retail sales in Hong Kong have more than doubled. Just as investors should not be euphoric about the Hong Kong retail property market during the boom days in 2009-13, probably they also need not be totally bearish now.

Hong Kong: growth in retail sales and retail space since 1985



Source: CEIC

Hong Kong: growth in retail sales and retail space since 2003

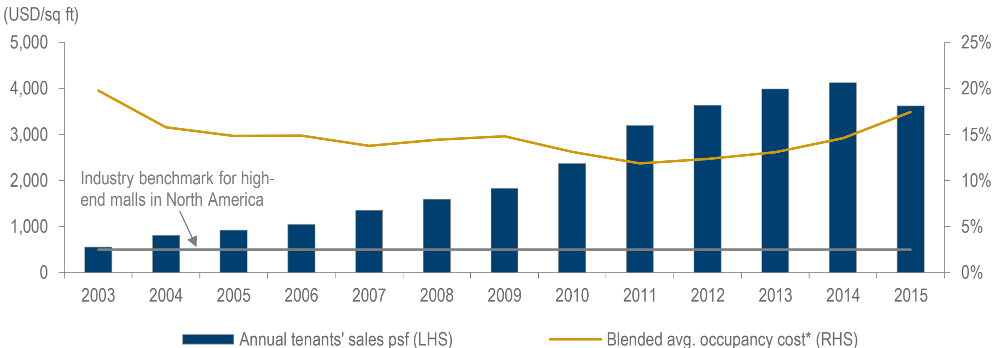


Source: CEIC, Daiwa

Retail space in Hong Kong remains productive by global standards, even after the correction

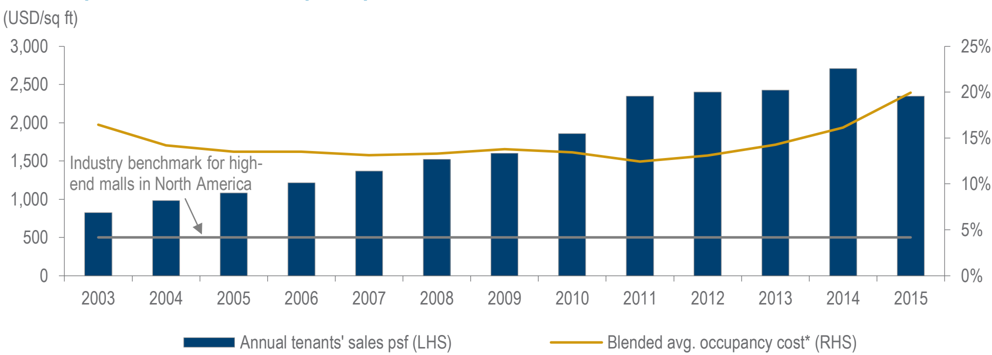
Note that in terms of retail sales productivity, Hong Kong retail property assets are still among the highest in the world, but occupancy costs appear still within a reasonable zone. After all, for retailers, it is sales productivity and occupancy cost that count the most. To sustain retail sales productivity, the Hong Kong retail property market needs a continued inflow of purchasing power, and an expansion in the size of its retail hub and scale to accommodate a greater variety of retailers and shoppers. How well the Hong Kong retail sector can do in this will determine its longer-term prospects, in our view.

Harbour City: achieved sales per sq ft



Source: Company, Daiwa estimates
*Note: *after adjusting for management fee and miscellaneous charges which have been included in reported gross revenue from rental*

Times Square: achieved sales per sq ft



Source: Company, Daiwa estimates
*Note: *after adjusting for management fee and miscellaneous charges which have been included in reported gross revenue from rental*

Office market: has it already overcome the challenges and moved on to the next phase?

A. Does the absence of high-profile leasing deals from MNCs mean there is little demand for office space? We think not …

Is the gradual expansion of existing corporations a favourable sign?

In terms of the Hong Kong office market, we believe that over the past few years, there has not been much high-profile expansion of office space by major banks or MNCs, which had been typical in Hong Kong in the past. While 2015 finally saw mainland financial institutions becoming a new source of office demand in Hong Kong, it remains to be seen how strong and sustainable such demand will be, especially given the volatility in the A share market. In the meantime, investment banks are still downsizing and it does not look as if this is going to end. As such, we think it is understandable that the market has been sceptical and bearish on the Hong Kong office sector.

That said, we would make several points. Our read is that the high-profile expansion of large MNCs tends to be characteristic of new office markets. For mature and developed office markets, one may not see that as often, nor is this necessarily desirable. It is sometimes said that MNC expansion tends to be a lagging indicator of the economy, and these decisions are as easily to err as to be correct. By way of contrast, gradual expansion by existing corporations, while less high profile, is arguably more healthy and often more heavily underpinned by profitability and realistic business expectations about the industry outlook.

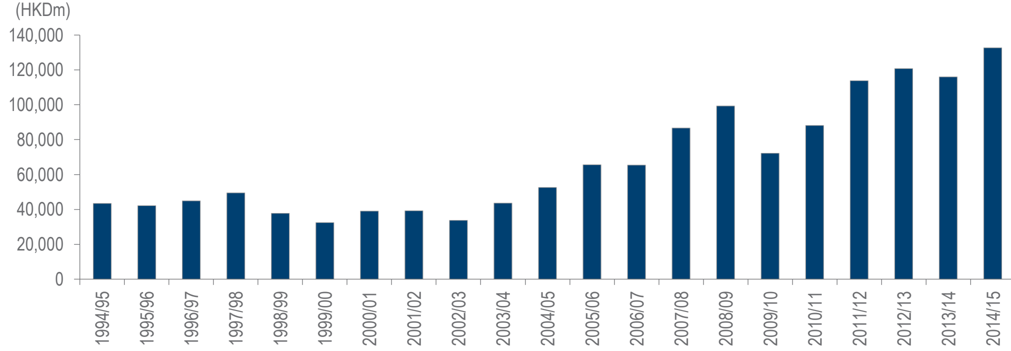
For all the pessimism about the Hong Kong office market, we think several points need to be noted. Since 2007, over 10m sq ft of office space has been completed in East Kowloon and has been absorbed, with rents more than doubling compared with the pre-2009 days. True, there has been no major high profile expansion of major industries, yet gradually new office space is being taken up by the natural and gradual expansion of existing corporations. Moreover, while these companies are not as high profile as large MNCs, we do observe that some industries have increased their presence notably in the Hong Kong office sector over the past 10 years. Health & beauty, business centres, medical, etc., are among the examples. In other words, while there has not been much high-profile business expansion in Hong Kong over the past decade, it is incorrect to say that there has been no expansion in office demand in Hong Kong during the period.

Aggregate corporate profitability looks healthy

Another point to note is that corporate profitability as a whole has kept on rising and is at a record-high, notwithstanding all the pessimism and concerns about Hong Kong. We see corporate profit tax paid as one of the most reliable indicators of the health of the office sector, as we assume that corporations would seldom overstate their profitability to the Inland Revenue Department. As such, we see corporate profit tax paid as the minimal level of aggregate profits in the Hong Kong corporate sector. Note that Hong Kong has adopted the “territory principle” in its tax system, meaning that corporations in Hong Kong do not need to pay tax on the profits they make outside Hong Kong, and this implies that the corporate profit tax paid by Hong Kong corporations would therefore tend to understate their true level of profitability.

Our take on the corporate profit tax figures in Hong Kong is that, while certain industries in Hong Kong could be facing problems, the overall aggregate profitability of the corporate sectors in Hong Kong still appears sound and solid.

Hong Kong: corporate profit tax paid



Source: HKSAR Government

The bottom segment of the HK office market appears to be doing well

Third, so far, it appears that the lower end segment of the Hong Kong office market has been doing well over the past few years. We see this as an important sign as the move of thousands of smaller companies is often a more reliable indicator than the high-profile expansion of some Fortune 500 MNCs. While the latter could be decided by just the CEO and some senior executives, the former is derived from the collective actions of thousands of smaller companies based on their assessment of the prospects of the underlying business environment. In our view, the later tends to be a much more reliable indicator of the state of the business environment and business expectations.

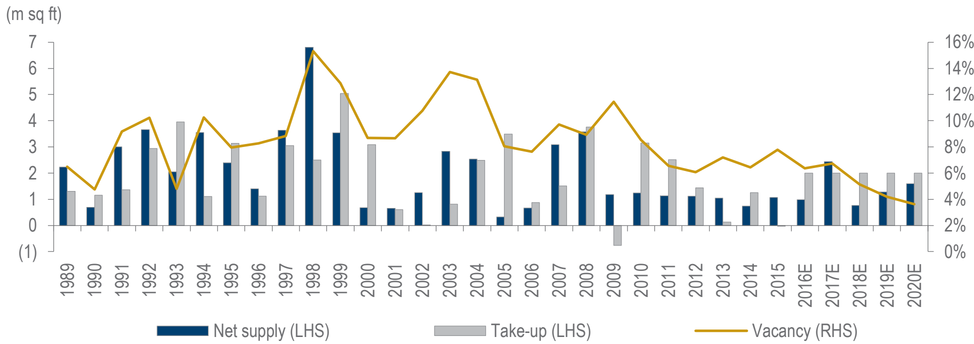
There are also other emerging office districts to provide a balance

Fourth, we are seeing new office districts continuing to emerge. The late 2000s saw the rise of Kowloon East as an office hub, and now Wong Chuk Hang and to a lesser extent, San Po Kong, Kwai Chung, etc., are showing signs of becoming the alternatives for corporations that find Kowloon East too expensive. Generally, we see the gradual and natural enlargement of commercial hubs as a positive sign for the commercial property market, and our read is that the underlying demand for Hong Kong office space in is stronger than it appears.

New supply in the core areas likely to remain tight in the foreseeable future

In any case, Grade-A office supply in Hong Kong is likely to remain tight in the foreseeable future. While some new office supply will likely emerge from 2018 onwards, we note that this supply is outside the traditional core areas (Central, Wanchai, Causeway Bay and Tsimshatsui) and quite a few are from redevelopment. We also note that the current overall office market vacancy rate in Hong Kong is below 3% and we believe landlords do not need to worry until the vacancy rate exceeds 5% (by global standards, a vacancy rate of up to 10% is still considered acceptable). As such, our read is that the Hong Kong office sector has a lot of cushion against adverse developments in Hong Kong and overseas. Meanwhile, given the tight supply in core areas, just modest new demand would probably be enough to exert some impact on the overall office sector.

Hong Kong: completions, take-up and vacancy of Grade-A offices



Source: CEIC, Daiwa forecasts

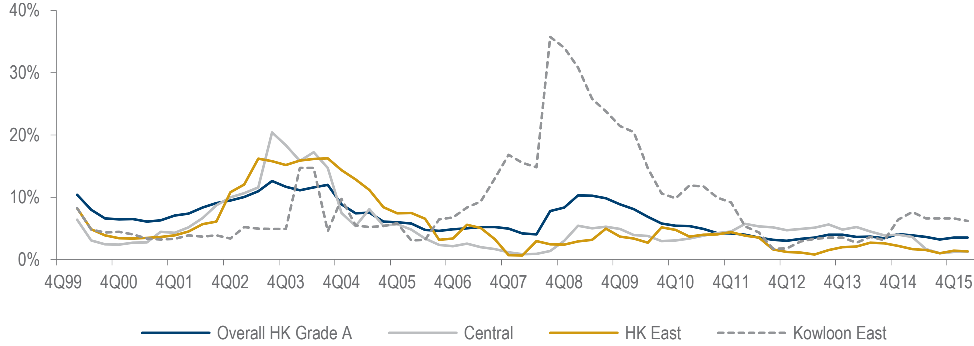
B. Is the office market showing the way for the other segments of Hong Kong property? We think so …

We see office as the leading segment in this cycle

From a broader perspective, we think the development and evolution of the Hong Kong Grade-A office sector is reflective of the overall situation of Hong Kong property. Indeed, we see office as the leading sector for Hong Kong property at this cycle. Like luxury residential and prime retail properties, Central Grade A office space saw a major rally in 2H03-2012 with rents rising by over 300% during the period. However, one feature about the Hong Kong office sector is that market participants have self-created a correction mechanism through tenants showing resistance to the Central office rent. At the same time, landlords have responded with alternatives such as ICC in West Kowloon and new projects in East Kowloon.

In retrospect, we think the Hong Kong Grade-A office sector is the healthiest among the 3 main property segments in Hong Kong in that it is the first segment to see the market saying that the kind of rally since 2H03 cannot continue. More importantly, the market has found a solution to the challenge by itself, by breaking the psychological barrier involved in relocating across the harbour and accepting Kowloon East as an alternative office location. This has in turn led to a sector-wide re-distribution of vacant office space in Hong Kong, provoking the sector to emerge from the adjustment starting in 2H14.

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



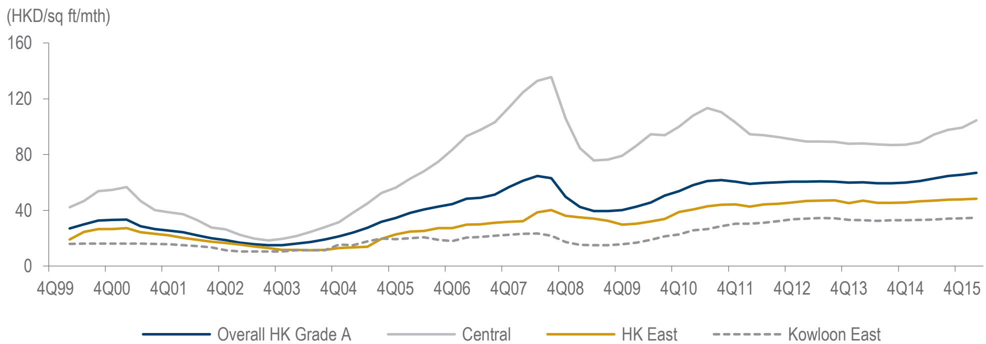
Source: CBRE Research, Daiwa

In our opinion, the current situation in the retail property market now bears some resemblance to the Central Grade-A office market in 2011, in that, in both cases, some segments over-expanded. For office, this was investment banks. For retail property, it is watch and jewellery retailers and luxury brands. In retrospect, the market was also full of gloomy forecasts on the Hong Kong office sector back in 2009, citing that the large supply from West Kowloon and East Kowloon, coupled with the GFC, could lead to a multi-year decline in Hong Kong Grade-A office rents.

We think the current structure of the Grade-A office market is healthy and balanced

This, however, did not happen in subsequent years. Instead, Kowloon East has emerged as a new office hub and helped to provide a good balance to the overall Hong Kong office sector, in that it provides a lower-cost option for corporates in Hong Kong. In our opinion, the current structure of the Hong Kong Grade-A office sector is healthy in the sense that, in every rental bracket occupiers have choices, and each segment provides a balancing force against rents in other districts having a run-away rise or decline.

Hong Kong: rents in major Grade-A office locations



Source: CBRE Research, Daiwa

Hong Kong: structure of Grade-A office stock

	Districts	A1 m sf.	A2 m sf.	A3 m sf.	Total m sf.
I	**Greater Central**				
	Core Central	**2.3**	7.6	5.8	15.7
	Admiralty and its Wanchai South extension	-	1.9	4.4	6.3
	Sheung Wan	-	-	4.4	4.4
		2.3	**9.5**	**14.6**	**26.4**
II	**The four core office districts**				
	Wanchai	1.4	1.0	5.4	7.8
	Causeway Bay	2.3	0.4	1.3	4.0
	Island East	1.3	4.9	2.8	9.0
	Tsimshatsui*	2.8	2.5	4.8	10.1
	West Kowloon*	2.0	-	-	2.0
		9.9	**8.7**	**14.2**	**32.9**
III	**East Kowloon**				
	East Kowloon	**2.6**	**5.7**	**5.4**	**13.6**
IV	**Tsimshatsui East, Hunghom, Mongkok**	**-**	**1.6**	**5.6**	**7.2**
V.	**Rest of Hong Kong**				
	Cheung Sha Wan and Kwai Chung	-	-	3.6	3.6
	Wong Chuk Hang	-	-	-	-
	New Territories	-	-	1.3	1.3
		-	**-**	**4.9**	**4.9**
		14.7	**25.5**	**44.8**	**85.0**

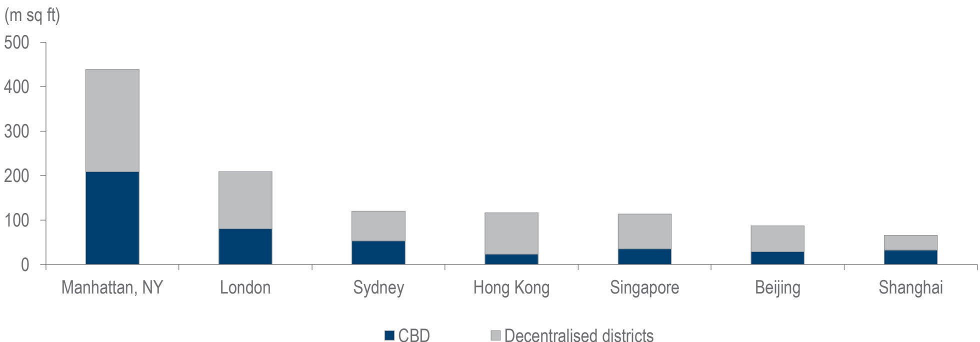
Source: Daiwa
*Note: * we consider Tsimshatsui and West Kowloon as one district*
For analytical purposes, we have divided buildings into 3 categories:
A1: The most prime buildings in a district and the upper benchmark for the achievable rentals in the area.
A2: Buildings whose quality is above average in a district, but are not prime enough to be setters of achievable rents in the district.
A3: Buildings that are at the lower-end in a district.

C. Will there be sustainable demand for office space in Hong Kong? We think so …

The stock size of Hong Kong's office sector is still not too large

In our opinion, the current structure of the Hong Kong Grade-A office sector is healthy, and the sector is now merely waiting for demand to pick up in a sustained way, which we see as possible. In terms of total Grade-A office stock, Hong Kong is still less than 50% of the scale of London or New York. Our understanding is that while demand from mainland corporations for new office space may have declined in recent months in relative terms, there are still many Chinese corporations that want to establish a presence in the territory. We believe many of the new tenants in Citibank Plaza and The Center are asset management companies. In our view, there are still many asset management companies in China and it is still early days in terms of Chinese financial institutions coming to Hong Kong.

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



Source: Knight Frank

We see considerable room for mainland corporations to expand their presence in Central

Based on a recent study by CBRE, some 23% of the Grade-A office space in Central was occupied by US corporations and 22% by European companies at the end of 2014. This compares with 19% for Chinese corporations and up to 29% for European companies back in 2008. As such, we see considerable room for mainland corporations to increase their presence in Central. Meanwhile, in the current cycle there has been sizeable demand for owning office buildings as reflected by the many en-bloc transactions in the office market over the past two years. We see this trend as a positive sign of some corporations' intentions to secure a long-term presence in Hong Kong.

Hong Kong: major en-bloc transactions of office buildings

Date	District	Building	Total GFA	Transaction price		Buyer	Vendor
			(sq ft)	Total (HKDbn)	psf (HKD)		
Feb 2016	Wanchai	Dah Sing Financial Centre	400,113	10.0	24,992	China Everbright group	SEA Holdings
Nov 2015	Wanchai	MassMutual Tower	345,500	12.5	36,188	Evergrande	Chinese Estates
Nov 2015	Hunghom	One Harbour Gate West Office Tower & West Retail Villa	393,000	5.85	14,900	China Life group	Wheelock

Source: Hong Kong Economic Times, Apple Daily

In all, we see the office sector as the leading sector for Hong Kong property in this cycle, and believe its development will show the way for the other segments. In common with retail and residential property, the Hong Kong office sector also boomed from 2H03 to 2010 led by its top-end segment, Central. However, our read is that the office sector has been the first to exhibit resistance to the rapid rise in prices and rent (starting with Central in 2011).

The Central office market was the first property segment to enter a correction in 2011 and saw a difficult period from 2011-13. However, after undergoing this adjustment, the Central market has regained its rigour, in our view, and the Hong Kong office sector as a whole has become stronger and should now be more resilient against adverse factors. In our opinion, the Hong Kong Grade-A office sector is the best-positioned among the 3 major property segments in Hong Kong to benefit from an increase in demand, and is on the verge of entering stage 3 of what we refer to as the metropolitisation process (ie, back to a more balanced growth path) (see the latter part of the report for a detailed explanation of this process and the various stages involved).

Take-up and vacancy rates in Grade-A offices since January 2015

	Net take-up (sq ft, NFA)		Vacancy rate (%)					
	Central	Overall	Central	Wanchai / Causeway Bay	Hong Kong East	Tsimshatsui	Kowloon East	Overall
Jan-15	5,300	36,100	3.7%	2.7%	1.2%	1.1%	7.1%	4.3%
Feb-15	1,800	61,700	3.7%	2.6%	0.9%	1.1%	8.0%	4.4%
Mar-15	126,300	271,300	3.2%	2.4%	0.9%	0.9%	7.1%	4.1%
Apr-15	167,700	224,600	2.5%	2.6%	1.1%	0.6%	7.1%	3.9%
May-15	55,200	862,300*	2.3%	2.5%	1.2%	0.6%	6.2%	3.7%
Jun-15	~68,000	~135,000	1.7%	2.3%	1.0%	1.5%	6.1%	3.5%
Jul-15	79,100	253,000	1.4%	2.0%	0.8%	1.7%	5.9%	3.2%
Aug-15	30,500	151,400	1.3%	1.7%	0.7%	1.6%	6.2%	3.0%
Sep-15	23,800	184,000	1.2%	2.1%	0.7%	1.6%	6.1%	3.0%
Oct-15	Net withdrawal	289,900	1.2%	1.9%	0.7%	1.5%	5.7%	2.8%
Nov-15	10,900	(27,200)	1.2%	2.0%	0.8%	1.6%	5.5%	2.9%
Dec-15	(7,100)	nd	1.2%	2.2%	1.1%	1.6%	5.5%	2.9%
Jan-16	(30,200)	48,000	1.3%	2.6%	1.4%	1.6%	5.1%	3.0%
Feb-16	11,500	(10,900)	1.3%	2.2%	1.0%	1.8%	5.2%	3.3%
Mar-16	Net withdrawal	(26,600)	1.4%	2.4%	0.8%	1.9%	5.2%	3.3%
Apr-16	Not disclosed	51,800	1.4%	1.9%	0.7%	2.0%	6.4%	3.4%

Source: Jones Lang LaSalle, Daiwa
*Note: *include 728,400 sq ft at One Bay East; nd = not disclosed*

Will other sectors follow the development of the office sector?

Importantly, if this development (a correction followed by a more balanced and sustainable growth) can happen in the office sector, we think there is no reason it cannot happen in the retail and residential sector as well – an issue we examine in greater detail in the next section.

4. Are we seeing a correction or a normalisation?

Does the track record for Hong Kong property justify some benefit of the doubt?

We think Hong Kong property deserves some benefit of the doubt

As we have outlined earlier, we believe the Hong Kong physical property market is more sophisticated and complex than it may appear. We do not dispute that, in some ways, Hong Kong is arguably one of the world's most risky property markets in terms of the magnitude of potential downward adjustment; however, periods of challenges and dangers have been faced by this market in the past, yet it has always pulled through. While past experience is not an indicator of future performance, we think the track record of this market affords it some benefit of the doubt.

It appears to us that experienced participants in the Hong Kong physical property market have indeed given the market the benefit of the doubt, and have been waiting for the right opportunity to invest further, with some having already started to make their move, as reflected in some major transactions in the physical market since February 2016.

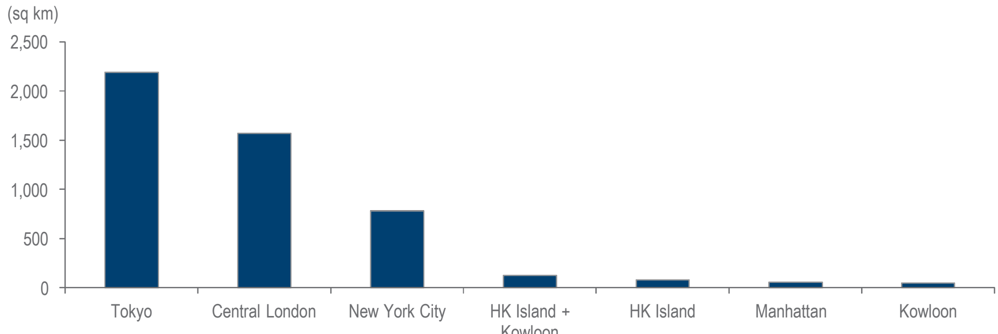
Are the investments made by corporations and wealthy individuals since the second half of February the last pool of ignorant money, or initial investments by the more forward-looking and far-sighted investors? Only time will tell. What we can say is that the amount invested in Hong Kong property market since the second half of February, while not small (at about HKD10bn), is far from exhausting the amount of capital available to the major property companies and wealthy in Hong Kong, which we estimate to be well over HKD100bn.

The development of major metropolitan cities often takes decades or longer

Meanwhile, based on our analysis of the historical development of the Hong Kong property market, as well as that of other major global cities, we believe it would be wise to take a longer-term view on these types of metropolitan property markets. If history is anything to go by, opportunities to buy into these types of property markets seldom arise, and if they do arise, rarely last for long. It is said by some that the only time one could buy property in New York on a big scale and at rock-bottom prices was in 1975 when the city was on the verge of bankruptcy – the impact from 911 and the Lehman crisis was not that large and did not last for long. Similarly, the impact of the GFC and the Euro debt crisis on the London property market was not large and did not last for long.

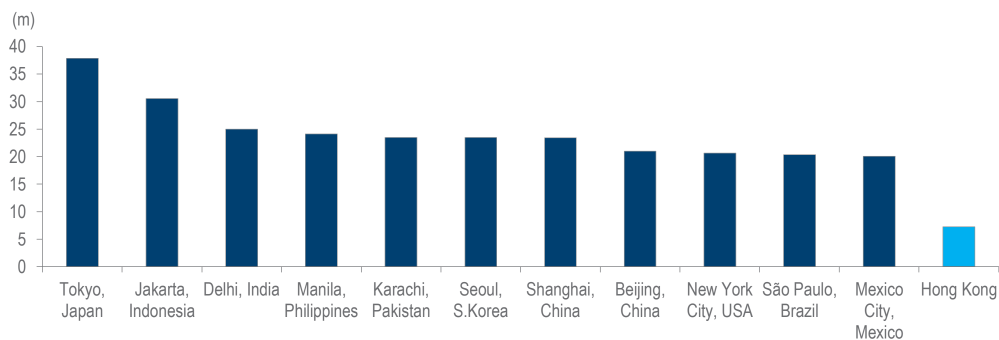
Importantly, based on the experience of London, New York and Tokyo, the full-blown development of a global city can easily take several decades or longer. We could say that over the past 4 decades, the Hong Kong property market has tried to accomplish what took London and New York over 100 years to achieve – and within the constraints of undertaking such development on a tiny piece of land not even 20% the size of London or New York, and smaller still in terms of the amount of flat land.

Hong Kong: land area vs. major international cities



Source: Wikipedia

Hong Kong: population vs. major international cities



Source: Wikipedia

We think a lot of the sky-high rents/prices and contradictions in the Hong Kong property market need to be seen in the context of the above, and in relation to the pace and magnitude at which Hong Kong has moved up from not much more than a fishing village just a few decades ago.

The pace and scale of China's rise is also another aspect to note

Another factor we would highlight is the pace and scale of the rise of China as an economic power and the ongoing impact it has on Hong Kong. We think it goes without saying that the pace at which China has risen as a global economic power is unprecedented. Only time will tell whether China's ascension will resemble the post-war industrialisation of Japan (which ended in an asset bubble, followed by 2+ decades of deflation) or the rise of the US as a global economic powerhouse (which has lasted for over 100 years). Whatever the case may be, Hong Kong being a small and unique city within China, is bound to continue to be affected by China's rise; and such large economic forces are bound to have a major impact on a small city like Hong Kong, where less than 200sq km of flat land has been developed so far, on our estimates.

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

As mentioned earlier, 1983 was the watershed year for the Hong Kong property market because that was the year the HKD was pegged to the USD; and ever since, the sector has been facing forces disproportionate to its size. We believe these forces worked in its favour from 2H03-2013, pushing rents and prices to record levels, especially for top-end assets. However, perhaps partly because of the lessons learned from the 4Q97-2Q03 downturn, we think market forces restrained prices and rents in the property market, preventing them from rising too far, and too fast. While certain segments in each of Hong Kong's major property asset classes have overshot (such as Central offices during 2011-2013, high street shops as well as Class A and B residential units since 2014), we contend that, everything considered, the participants in the Hong Kong property market exhibited a fair amount of prudence, restraint and sophistication against many appealing invitations to irresponsible and opportunistic investment and misallocations of capital by corporations, individuals, investors, etc., during the 2H03-2014 period.

In our opinion, it is enlightening see the Hong Kong property market as a metropolitan property market, in that it is driven by the city's emergence as a stronger and more relevant international city. Seen in this light, we think the Hong Kong property market is still at about the middle point of its development, with the office market having already entered phase 3, while its residential and retail segments are still in phase 2 (see following chart and table).

Current position of the 3 property segments

Source: Daiwa

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

The recent retreat of the 2 tidal waves is a blessing in disguise, in our view

Against this background, the retreat of the 2 tidal waves (exceptionally low interest rates and the rise in number of Chinese consumers in the global retail market) since 2014, while posing a challenge for the Hong Kong property market, may also be a blessing in disguise. In our opinion, had the 2 tidal waves continued or accelerated, sooner or later Hong Kong's property market could have seen a serious and widespread misallocation of capital and disastrous investments, resulting in newcomers to the Hong Kong residential property sector drying up, and the Hong Kong retail landscape becoming dull and homogenous, dominated by watches and jewellery as well as luxury brands which would not appeal to the majority of shoppers.

We would reiterate our view that the Hong Kong office market is the healthiest among the 3 segments and can be seen as the leading segment in this cycle. In retrospect, we think the most important development in the Hong Kong property market in this cycle is the creation of forces (such as the breaking down of corporations' psychological barrier associated with moving across the harbour, accepting Kowloon East as an alternative office hub, and companies' willingness to relocate to lower-tier districts and buildings, landlords' commitment to upgrade the quality of the buildings, etc.) that have restrained the amount and level of excesses in the upper end segment of the sector. And these forces, by and large, have been created by the market itself (government policies have helped, but we believe a large part of the self-correcting forces have been created by the industry participants themselves).

Could it be just correction or a normalisation?

Our central argument holds that the fall in rents, prices, and demand since 2H15 could just be a correction rather than an unwinding of all the positive factors that have occurred since 2H03. Outlined below are the scenarios we see, other than a complete meltdown, and the hallmarks for the meltdown as well as each of the other scenarios.

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 4Q15-2Q16. 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

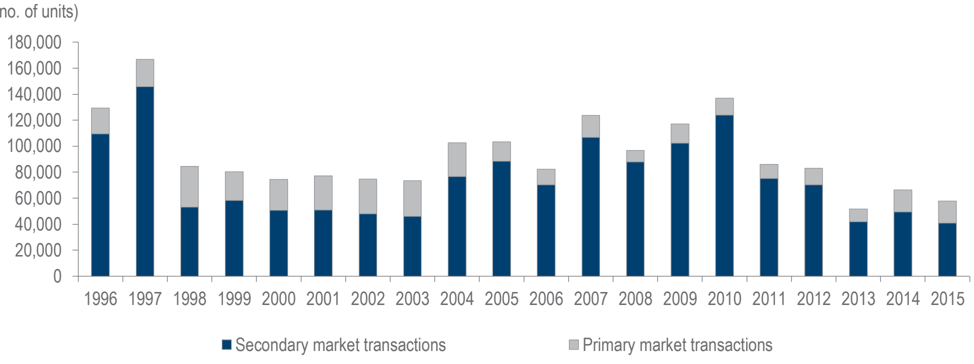
	Very pessimistic case	Pessimistic case	Base case	Optimistic Case	Very optimistic case
Mainland corporations	Decide to close down their Hong Kong operations.	Postpone their expansion in Hong Kong.	Gradually increase their presence in Hong Kong.	Become keen to establish a larger presence in Hong Kong.	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

Our base case calls for a correction; we think adjustment/ normalisation is conceivable but share prices have discounted a much worse scenario ...

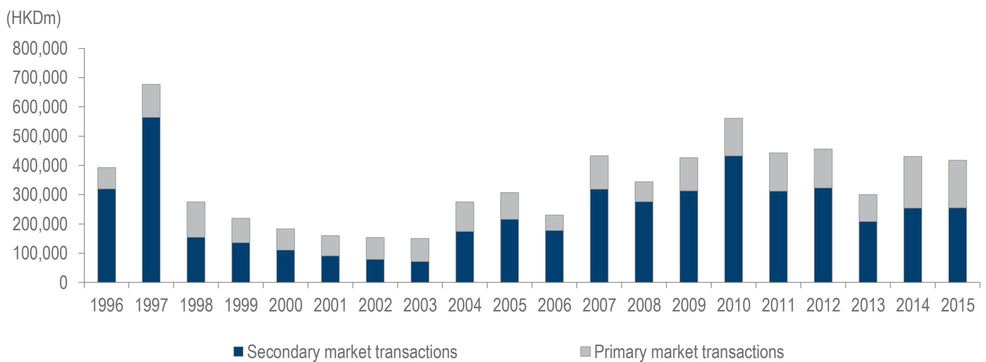
Outlined above are scenarios that range from a meltdown to an adjustment/normalisation to a breakthrough. Our base case is for a correction scenario; and we would say that an adjustment/normalisation scenario is conceivable, and if the market participants can respond pro-actively and creatively to the present challenges, a breakthrough scenario is not totally inconceivable. However, share prices seem to be expecting a gradual meltdown scenario, but we think that is too pessimistic. We see the possibility of other scenarios, but it looks as if the current share prices of Hong Kong property companies have neglected such possibilities. This is before we take into account the fact that there is a subtle but important difference between corporate fundamentals and industry fundamentals. We think the industry fundamentals underpinning Hong Kong property are not that bad, but corporate fundamentals are much stronger; and in terms of pricing property companies, corporate fundamentals are of greater importance than industry fundamentals, in our view. We examine this topic in greater detail in the next section.

Relative size of the Hong Kong primary and secondary residential market (volume)



Source: Midland, Daiwa

Relative size of the Hong Kong primary and secondary residential market (value)



Source: Midland, Daiwa

We do not expect a collapse in Hong Kong property prices

Daiwa forecasts of Hong Kong property prices

	2014	2015	2016E
Rents			
Shopping malls	+6%	+3%	-5%
High Street shops	na	-30%	-20%
Overall retail	+6%	+3%	-6%
Central grade-A office	+4%	+15%	+5%
Overall office	+4%	+8.5%	+5%
Mass-residential property	+7%	+4%	-10%
Prices			
Mass-residential property	+11%	+3%	-10%

Source: CEIC, CBRE, Jones Lang La Salle, Savills, Midland, Centa-City leading Index, Daiwa forecasts

5. Can property companies pay more dividends and modernise their capital management?

Corporate fundamentals are stronger than industry fundamentals

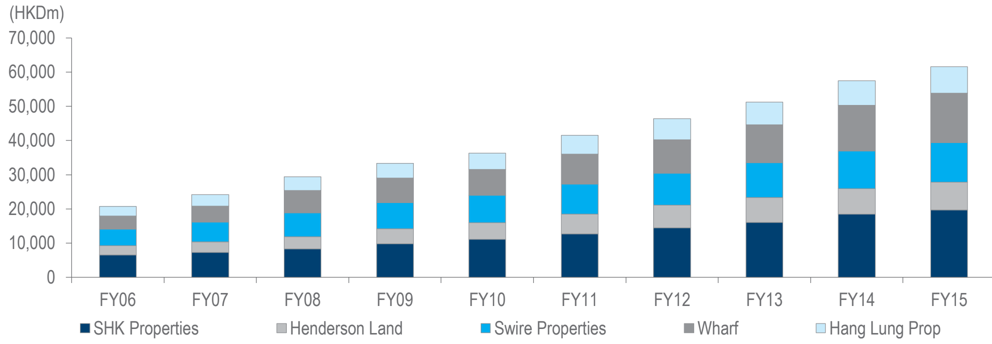
Corporate fundamentals are appreciably stronger than industry fundamentals, in our view

We think one aspect not fully appreciated by the market is the significant distinction between industry fundamentals and corporate fundamentals. We believe this distinction is of particular importance to the Hong Kong property sector now because, first, the industry fundamentals are much more resilient and better than the market seems to have expected. But our second point is arguably even more important: the corporate fundamentals of the Hong Kong property sector are notably stronger than those of the industry, in our view.

We believe these superior company fundamentals reflect the following factors:

1) The business models of the Hong Kong property companies have evolved to a point where the companies have much stronger recurrent incomes than before and their business development is far less constrained than ever by conditions in any of Hong Kong's property segments.

Aggregate rental income of 5 major property companies



Source: Companies

2) When Hong Kong property was going through its bull run from 2H03-2015, the Hong Kong property companies did not respond as though the run would last. Instead, they kept their gearing low and used the windfall gains to build up their investments in the China property sector — investments that are now bearing fruit, as evidenced by these companies' most recent results announcements.

Hong Kong property companies: net gearing ratios

Company	Dec 2014	Dec 2015	YoY chg
CK Property	na	5.7%	na
Great Eagle	Net cash	Net cash	na
Hang Lung Properties	Net cash	1.1%	na
Henderson Land	15.7%	16.0%	+0.3pp
Hongkong Land	10.0%	8.0%	-2.0pp
Hysan	4.2%	3.0%	-1.2pp
Kerry Properties	28.5%	32.2%	+3.7pp
MTRC	7.6%	11.3%	+3.7pp
New World Dev	13.0%	13.0%	0.0pp
SHK Properties	13.8%	12.4%	-1.4pp
Sino Land	Net cash	Net cash	na
Swire Properties	16.3%	15.3%	-1.0pp
Wharf	18.9%	14.9%	-4.0pp
Wheelock	18.8%	16.0%	-2.8pp

Source: Companies, Daiwa

3) What the market seems to have missed is that many companies have continued to raise their DPS over the past 10 years. The highest DPS CAGR is Link REIT's, at 13% since FY07, its first full year of listing. But those of Wharf, Hysan and MTRC are not far off, at 11%. All, we highlight that for the companies shown in the table below, the DPS in FY15 was on average 115% higher than their DPS in FY06.

DPS of major Hong Kong property companies

Company	Year end	DPS/DPU (HKD)										Change FY15/	CAGR FY15/
		FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	FY06	FY06
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*

The Hong Kong property companies have kept on raising their DPS

We note that the past few years have been characterised by the significant purchase of shares of these companies on the open market by their major shareholders. Indeed, on our estimates, the major family property companies in Hong Kong have spent over USD6bn on raising their stakes in their listed vehicles in recent years — the largest-ever amount of insider purchases in Hong Kong and certainly a large sum even by global standards. With the families having substantially increased their stakes in their listed vehicles, and the companies' recurrent rental income becoming stronger than ever, we think the chance that the Hong Kong property companies would continue to raise DPS is also strengthening.

Hong Kong property: buying by "insiders" in recent years

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*

Also, there seems to have been an evolution in the way these companies view the capital market. We note that over the past 6-24 months, some companies have taken modest but nonetheless important steps in this regard, most notably Cheung Kong Group's re-organisation (January 2015) and Cheung Kong Property's share buyback (March 2016). These moves were unprecedented for the Cheung Kong Group and, indeed, the major family property companies in Hong Kong. Given that the Cheung Kong Group used to be a pioneer in the Hong Kong corporate sector in many respects, its moves could have important implications for the sector 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%
Total	**13,535,000**	**46.725**	**632.4**	**0.351%**

Source: HKEx

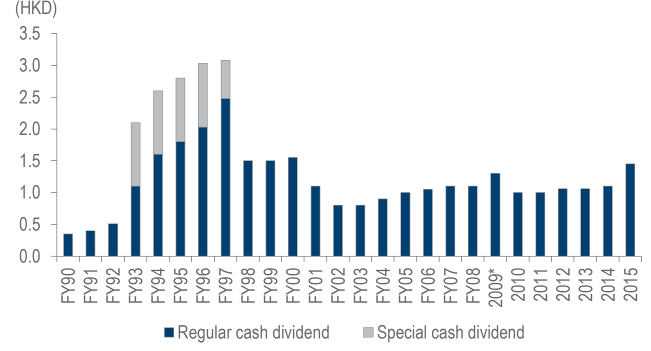
Hong Kong property companies: significant corporate actions in recent years

Companies	Year	Corporate actions	Remarks
Sunlight REIT	2012	Declared intention to sell non-core assets to realise NAV and use the proceeds for unit buybacks	The first one to articulate such a strategy, though the scale of asset disposal and unit buyback was modest
Henderson Land	2012-2016	Declared four consecutive yearly 1-for-10 bonus issues since FY12 while at the same time raising its absolute DPS	A commitment to pay more dividends to shareholders; total cash dividends paid for FY15 were 88% higher than in FY12
		DPS for FY15 rose 32% YoY to HKD1.45/share.	
Link REIT	2014	Started to dispose of non-core assets and declared it would use the sales proceeds for unit buybacks to offset the impact on DPU as a result of the loss of rental income	The first to embark on such a strategy on a systematic and consistent basis
		So far, all the achieved prices were at premiums to book value and the buybacks were all at discounts to the reported book value	A safe and rational way to recycle capital into higher-quality assets and to realise NAV
Wheelock	2014-2016	Sale of Crawford House (HKD5.8bn in 2014) and Wheelock House (HKD5bn in 2016) to Wharf, after spending a similar amount on buying Wharf shares in the open market	This resembles an "arbitrage" between the physical market prices and stock prices – realising NAVs through the physical property market and then using the proceeds to buy stocks that are trading at notable discounts to NAV
Hysan	2015	Bought back 6.75m of its own shares for HKD215m	Declared that the company sees share buybacks as a way to "further enhance shareholders' value."
MTRC	2015	Declared a special dividend of HKD4.40 to shareholders	Also declared it would maintain its stated progressive dividend policy, whereby it would keep on growing absolute DPS irrespective of fluctuations in reported underlying net profits
Great Eagle	2015	Declared a special dividend of HKD2.0/share	A case of returning capital to shareholders when management judges that the business has surplus capital
Cheung Kong Group	2015	Cheung Kong Group re-organisation	Many interpretations are possible, but we would see it as the first major step taken by a major family business group in Hong Kong, or indeed Asia, to try to modernise and move towards becoming a truly global listed company
New World Dev	2015	Sold China property assets to Evergrande to realise NAV and subsequently made a second attempt to privatise New World China Land	A case of recycling capital and privatisation to capitalise on the gap between market values in the physical property market and stock-market valuation
CK Property	2016	Initiated share buyback after results announcement	The first ever share purchase made by the Cheung Kong Group and the major Hong Kong property companies
			The Cheung Kong Group used to be a pioneer in the Hong Kong corporate sector in many respects, and this move should have an impact on the capital management of the Hong Kong family property companies over time

Source: Companies, Daiwa

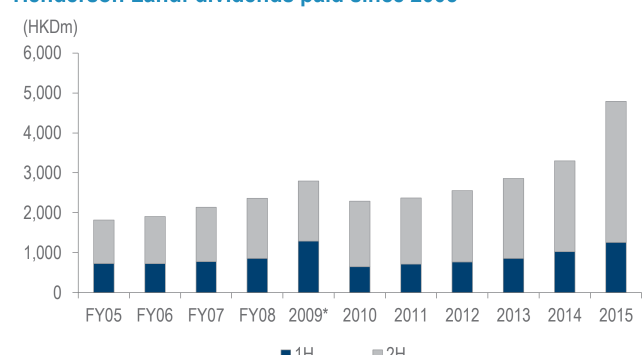
At the same time, our view of Henderson Land's dividend policy in recent years is that the company is committed to paying increased dividends, and the chairman's move to meet investors at its most recent results briefing is an important development (see also our note on *Henderson Land, Commitment to deliver return to shareholders*, 23 March 2016).

Henderson Land: historical DPS**



Source: Company
*Note: *for the 18 months to 31 Dec 2009 (company's year-end date was changed in 2009 from Jun to Dec)*
***Actual cash DPS declared, before adjusting for 1:10 bonus issues in 2012, 2013, 2014 and 2015*

Henderson Land: dividends paid since 2005



Source: Company
*Note: *for the 18 months to 31 Dec 2009 (company's year-end date was changed in 2009 from Jun to Dec)*

Is now the beginning of a structural change in Hong Kong family property companies' capital management?

While it seems the stock market has yet to take these moves seriously, and perhaps does not view them as signs of a broader modernisation of capital management by the family property companies, our view is that they do warrant investors' attention as they represent an investment theme in the making. In our opinion, these modest steps could be the beginning of a structural change in the dividend policies of the family property companies and the way they manage capital — factors that today are central to the large NAV discounts of the Hong Kong property companies. If this trend does continue, we would see it as a gradual — but credible, powerful and sustaining — catalyst to reduce the valuation anomaly related to Hong Kong property stocks.

Here we delve more deeply into the aforementioned issues, beginning with the evolution of the business models of the Hong Kong property companies.

1) Strong rental income base and opportunities to buy land cheap should protect corporate fundamentals from market weaknesses and uncertainties

These companies have achieved impressive growth in rental income but have yet to be rewarded by the market

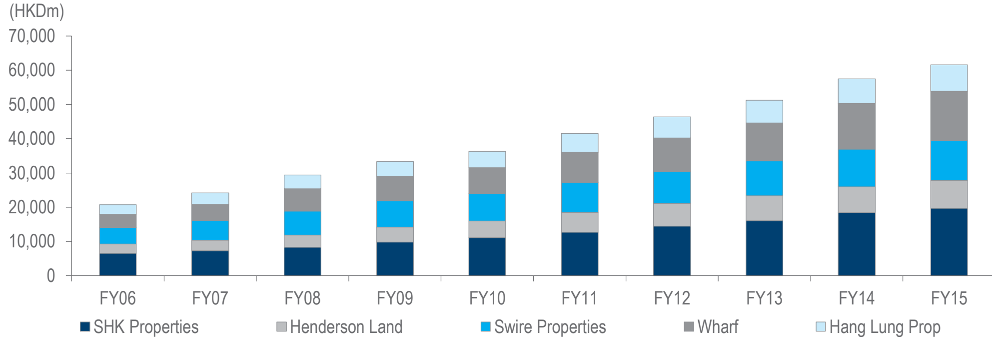
In our opinion, there is a close and intricate relationship between the business models of the Hong Kong property companies and the Hong Kong property market they operate in. Perhaps because of the booms and busts experienced by the Hong Kong property market in the past, property companies in Hong Kong have been unusually prudent in managing their balance sheets and asset mix, in our view. As such, the Hong Kong property companies' gearing is among the lowest in the world.

Moreover, unlike most property companies in the world, the Hong Kong family property companies tend to be exposed to all key segments of the local market, rather than focusing only on, say, the retail, office or residential segments. Indeed, our view is that it could be more productive to look at the Hong Kong family property companies as builders of family wealth for the long term rather than as typical property companies which tend to focus on specific segments where they have the most expertise.

Certainly, it seems that many of the Hong Kong family property companies are not making it a top priority to excel in any one segment. Rather, they are more intent on ensuring they have the financial strength and recurrent income bases needed to weather even the most severe and unexpected crises, and take advantage of land purchase opportunities during periods of market weakness.

In any case, we believe that, since the 1990s, nearly all the major Hong Kong property companies have focused on building up their recurrent rental income bases, a trend reinforced by the property market downturn of 4Q97-2Q03, which we think taught many players the value of having a strong recurrent income base. As we see it, many Hong Kong family property companies now have rental income bases that are several multiples the size of their corporate overheads and annual interest payments. In other words, they can survive — and probably still maintain their dividends — even if they do not sell a single residential unit for a year or indeed many years.

Aggregate rental income of 5 major property companies



Source: Companies

As shown in the table below, some of the developers have 7-12% gross yields on market capitalisation. Significantly, many of these companies' gross rental income per share are considerably larger than their current DPS, and with the size of their completed rental properties – and hence gross rental income – likely to continue rising, they should be well capable of sustaining a continuous rise in DPS. We note that, at current valuations, several developers can offer dividend yields of 4%-plus (Hang Lung Properties' yield is more than 5%). If most of these companies can offer yields exceeding that of Link REIT (823 HK, HKD46.4, Buy [1]) (4.6% based on our FY17 DPU forecast), we think the family property companies will attract more attention from global funds, income funds and other investors.

Hong Kong property companies: implied gross rental yield on market cap

	CK Property	SHK Properties	Henderson Land	Sino Land	Wharf	Swire Properties	Hongkong Land	Hang Lung Properties	Hysan
Share price (HKD)	45.25	86.95	44.45	11.40	41.35	19.90	USD6.08	14.22	31.60
Market cap (HKDm) = (b)	174,032	251,720	146,947	70,291	125,332	116,415	111,579	63,947	33,076
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)	**4.1%**	**8.3%**	**5.5%**	**5.2%**	**11.5%**	**9.9%**	**6.8%**	**12.1%**	**10.4%**
Gross rental income per share (HKD)	1.9	7.3	2.5	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	**3.1%**	**4.3%**	**3.3%**	**4.4%**	**4.6%**	**3.6%**	**3.1%**	**5.3%**	**4.2%**

Source: Companies, Daiwa, prices as of 23 May 2016

Nearly all of the major Hong Kong property companies now have much stronger bases of recurrent rental income compared with the past, and they have broader exposure outside the Hong Kong property market. Many also seem much more mindful of the scope for value creation through managing their commercial property assets better. These developments mean that the companies are much less affected than before by volatility in the property market.

Weak industry environment can herald opportunities to buy land at attractive prices

Indeed, property market downturns can serve these companies well by presenting them with an opportunity to buy large prime sites relatively cheaply. After all, in Hong Kong, one of the key requirements for success in the property business is to buy land at low prices, which is not so easy to do so when the supply of land is monopolised by the government and competition for land is keen. Given these conditions, it is only during market downturns or periods of uncertainty in the industry that property companies can buy large plots of land at attractive prices.

In retrospect, the foundations for SHK Properties' present HKD20bn annual gross rental income base were laid in the downturn of 4Q97-2Q03, which allowed the company to buy the sites for IFC and ICC at attractive prices. Similarly, the basis for Sino Land's transformation into one of the major players in Hong Kong residential property was established in the downturn of 4Q97-2Q03, when the company acquired about 6m sq ft of landbank at attractive prices.

In sum, we believe that Hong Kong property companies are far less affected by weakness in any one segment of the property market than many observers realise. Indeed, if history is anything to go by, market weakness or uncertainties may well present these companies with as many opportunities as risks.

2) China investments starting to bear fruit

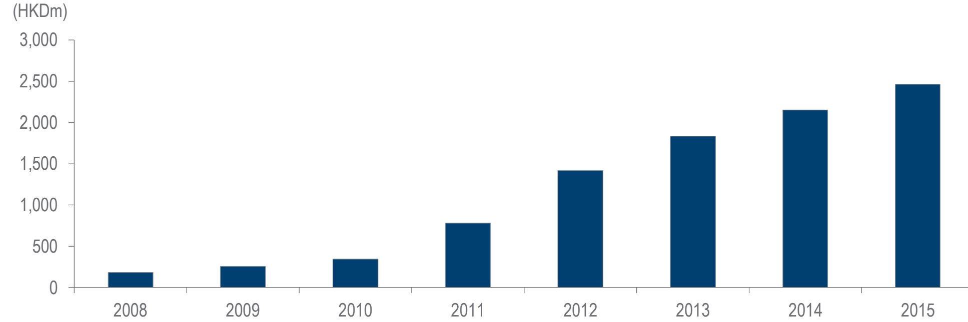
Investments in China have started to bear fruit

We think another major factor that is under-appreciated is that the Hong Kong property companies have not responded to the low-interest-rate environment by massively leveraging up to buy land or property assets. Instead, many seem to have treated the property market boom during 2H03-2014 as a windfall bonus; rather than leveraging up, they used the windfall gains to expand their presence in China property.

After well over 10 years, many Hong Kong property companies seem to have found the way to manage prime commercial properties in China. We believe that the Hong Kong property companies' China investments are starting to bear fruit, as evidenced by their most recent results announcements.

Although the scale of Hong Kong property companies' residential property businesses in China cannot match that of the largest domestic players, we believe the Hong Kong companies' land costs are competitive, as they still have a large amount of low-cost land bought back in 2007 or before since their production scale is much smaller than the major domestic players (many of whom *have already exhausted the land they acquired in the early days*). Also, comparatively speaking, the Hong Kong players tend to have more of a presence in the major tier-1 and tier-2 cities, as well as better margins. On both counts, the stock market has not fully recognised these positives for the Hong Kong property companies, in our opinion.

Swire Properties: gross rental income from China



Source: Company

Hong Kong property companies: China rental income in most recent results

(HKDm)	Interim / Final	Dec 2014	Dec 2015	YoY chg
China gross rental income				
Hang Lung Properties	Final	3,916	4,194	7%
Henderson Land	Final	1,480	1,748	18%
Hui Xian REIT	Final	2,729	3,059	12%
Hysan	Final	286	295	3%
Kerry Properties	Final	2,294	2,897	26%
Spring REIT	Final	631	624	-1%
SHK Properties	Interim	1,631	1,758	8%
Swire Properties	Final	2,153	2,463	14%
Wharf	Final	1,984	2,305	16%
Yuexiu REIT	Final	1,885	2,052	9%
Total		**18,989**	**21,395**	**13%**
Gross rental income from various retail malls				
Chengdu IFS	Final	483	605	25%
Beijing Oriental Plaza mall	Final	1,340	1,378	3%
Plaza 66	Final	815	885	9%
Grand Gateway 66	Final	1,157	1,196	3%

Source: Companies, Daiwa

Hong Kong property companies: China property sales profit in most recent results

(HKDm)	Interim / Final	Remarks	Dec 2014	Dec 2015	YoY chg
CK Property	Final	Op profit (incl JV & asso)	1,401	10,093	620%
Henderson Land	Final	Attri op profit (incl JV & asso)	660	631	-4%
Hongkong Land	Final	Underlying net profit	1,387	1,341	-3%
Kerry Properties	Final	Gross profit	759	602	-21%
SHK Properties	Interim	Op profit (incl JV & asso)	594	762	28%
Wharf	Final	Op profit (incl JV & asso)	2,781	4,200	51%
Total			**7,583**	**17,629**	**132%**

Source: Companies, Daiwa

3) Signs of improvement in dividend and capital management

Companies have been raising their DPS and payout ratios

Most importantly, we have seen changes in the dividend policies of the Hong Kong property companies in recent years. With the strengthening of their recurrent rental income bases, many Hong Kong property companies have been gradually raising their dividends, and in our view this was a key theme in the most recent results announcements. And, given the Hong Kong property companies' strengthening recurrent rental bases, we see scope for further increases in dividends going forward.

Hong Kong property companies: DPS for 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: *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	5,138	105%
Hang Lung Prop	3,373	7,751	44%
Henderson Land	4,794	8,152	59%
Hongkong Land*	USD447	USD851	53%
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 excludes contributions from JVs and associates*

Some initial signs of change in the capital management of the Hong Kong property companies

At the same time, some Hong Kong property companies have taken new steps in terms of capital management and corporate action. For example, over the past 2 years, we have seen corporate actions, including 1 group restructuring, 1 privatisation, continued insider purchases, asset disposals followed by share/unit buybacks, recycling of capital through asset disposals, and paying out special dividends following asset disposals to realise NAV. And, front and centre among these moves is Cheung Kong's share buybacks totalling USD81m undertaken on 18-21 March 2016.

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%
Total	**13,535,000**	**46.725**	**632.4**	**0.351%**

Source: HKEx

We consider the abovementioned developments to be important milestones, given our view that capital management lies at the heart of the currently large NAV discounts of the Hong Kong property stocks.

Significant improvement in recurrent rental income has yet to be rewarded by the market

We think it fair to say that investors are under the impression that many Hong Kong property companies are not concerned at all about their share prices. But we would not take an apparent lack of interest in stock prices as a sign that management teams do not care at all about the capital market or investors' interests and opinions. At least as far as corporate disclosure goes, we believe that the Hong Kong property companies have improved considerably over the past 20 years — more information is disclosed on a regular basis, management representatives spend more time meeting investors, and there are more regular analyst meetings and NDRs. In our view, paying higher dividends and/or repurchasing shares/units could be the next step forward for companies, and indeed some are already making moves in this direction. The Hong Kong property companies have changed and evolved in the way they face the global capital markets, albeit that the pace has probably not been as fast as the market would like.

NAVs and book values are well supported by realisable prices in the physical market

In our opinion, another factor working in favour of the Hong Kong property companies is that their NAVs are backed by the value of their physical property assets, which has become increasingly transparent and liquid thanks to the arrival of mainland and overseas capital in recent years. As a matter of fact, many multi-billion dollar deals have been completed in Hong Kong in the past few years and the achieved prices indicate that, while the cap rates Hong Kong property companies use are on the low side by global standards, they are conservative relative to the realisable values in the physical market.

Major property transactions in Hong Kong in recent years

Date	Property assets	District	GFA (sq ft)	Buyer	Vendor	Price (HKDm)	Price (HKD/sq ft)	Implied cap rate*	Remarks
Office property									
Feb 2016	Dah Sing Financial Centre	Wanchai	400,113	China Everbright group	SEA Holdings	10,000	24,992	Not disclosed	En-bloc
Nov 2015	MassMutual Tower	Wanchai	345,433	Evergrande	Chinese Estates	12,500	36,186	2.0%	En-bloc
Nov 2015	One HarbourGate (west tower)	Hunghom	393,000	China Life Insurance	Wheelock	5,850	14,885	3.0%	En-bloc, under-construction
Aug 2014	35 Queen's Road Central	Central	21,390	Not disclosed	Fook Lee Group	1,600	74,801	Not disclosed	En-bloc
Jun 2014	One Bay East (east tower)	Kowloon East	512,000	Citigroup	Wheelock	5,425	10,595	3.3%	En-bloc, under-construction
Dec 2013	9 Chong Yip Street	Kowloon East	136,595	Prosperity REIT	Hutchison Whampoa	1,010	7,394	3.0%	En-bloc
Dec 2013	DCH Commercial Centre	Island East	389,000	Swire Properties & an investment fund	CITIC Pacific	3,900	10,026	3.8%	En-bloc
May 2013	Kowloon Commerce Centre	Kwai Chung	116,756	China Mobile	SHK Properties	1,027	8,800	3.0%	5 floors
May 2013	Citibank Plaza	Central	78,316	Champion REIT	HKSAR Government	2,160	27,581	3.0%	4 floors
Apr 2013	One Bay East (west tower)	Kowloon East	512,000	Manulife	Wheelock	4,500	8,789	4.0%	En-bloc, under-construction
Feb 2013	113 Argyle Street	Mong Kok	328,866	Hang Seng Bank	Nan Fung (unlisted)	2,900	8,818	3.4%	En-bloc
Oct 2012	AIA Tower (formerly Stanhope Hse)	Island East	299,615	AIA	Hang Lung Properties	2,398	8,004	3.6%	En-bloc
Dec 2012	Exchange Tower	Kowloon East	195,875	Hang Seng Bank	Sino Land	1,560	8,000	3.8%	7 floors
May 2012	50 Connaught Road	Central	180,000	Agricultural Bank of China	National Electronics	4,880	27,111	3.5%	En-bloc
Jan 2012	CCB Centre	Kowloon East	348,620	China Construction Bank	Sino Land	2,510	7,200	4.0%	En-bloc
Retail property									
Dec 2014	Laguna Plaza	Kwun Tong	163,203 (GRA)	Fortune REIT	CLSA Property Fund	1,919	11,755 (GRA)	4.3%	En-bloc
Aug 2014	Lions Rise mall	Wong Tai Sin	126,319	Link REIT	Kerry Properties	1,380	10,924	2.4%	En-bloc
Jul 2014	Bigfoot Centre	Causeway Bay	67,150	CLSA Property Fund	Macau investor	1,600	23,827	Not disclosed	En-bloc
Jan 2014	8 Russell Street	Causeway Bay	81,000	Individual investors	CLSA Property Fund	2,500	30,864	1.9%	Strata-title sales
Jun 2013	Kingswood Ginza mall	Tin Shui Wai	665,244	Fortune REIT	Cheung Kong	5,849	8,792	4.1%	En-bloc
Feb 2013	OLIV, 15 Sharp Street East	Causeway Bay	37,500	Individual investors	Local family	1,450	38,800	1.5%	Strata-title sales
Jan 2013	The SHARP, Sharp Street East	Causeway Bay	44,500	Individual investors	Soundwill	1,500	33,576	1.8%	Strata-title sales
Jul 2011	Festival Walk	Kowloon Tong	1,195,248	Mapletree Investment	Swire Properties	18,800	18,063	4.6%	En-bloc

Source: Savills, CBRE, Hong Kong Economic Times, Daiwa
*Note: *based on estimated sport rent for comparable buildings in the area*

Indeed, whenever Hong Kong property companies have disposed of non-core assets, the achieved market values have often been at premiums — sometimes 50%-plus premiums — to the revalued book value from just a few months prior, as the following table shows.

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 four 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 in 2013	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

Link REIT has taken new steps in capital management

Another important development is that Link REIT has been pursuing a strategy of disposing of bottom-tier assets in Hong Kong to raise capital and swap into higher-quality assets with better long-term potential. The results indicate that even Link REIT's bottom-tier assets can achieve cap rates of just over 3%, based on the net property income (NPI).

Link REIT: achieved prices of asset disposals

1) Tender awarded on 20 May 2014, completed on 31 Jul 2014

District	Property name	Internal Floor area (sq ft)	Car-park spaces	Valuation as at 31 Mar 2014 (HKDm)	Net property income in 1H FY14 (HKDm)	Net property income in 1H FY14 (% of total portfolio)	Consideration (HKDm)	Implied yield* (%)
Shau Kei Wan	Retail and car park in Tung Hei Court	6,340	146	43	1.4	0.05%	73	3.8%
Lam Tin	Hing Tin Commercial Centre	28,313	387	188	4.4	0.18%	210	4.2%
Aberdeen	Wah Kwai Shopping Centre	41,878	413	366	9.3	0.37%	518	3.6%
Kwai Chung	Kwai Hing Shopping Centre	24,664	277	299	6.8	0.27%	439	3.1%
Total		**101,195**	**1,223**	**896**	**21.9**	**0.87%**	**1,240**	**3.5%**

2) Tender awarded on 29 Sep 2014, completed on 1 Dec 2014

District	Property name	Internal Floor area (sq ft)	Car-park spaces	Valuation as at 31 Jul 2014 (HKDm)	Net property income in FY14 (HKDm)	Net property income in FY14 (% of total portfolio)	Consideration (HKDm)	Implied yield^ (%)
Choi Hung	Retail and Car Park within Choi Fai Estate	1,045	93	38	1.9	0.04%	41	4.7%
Kowloon Bay	Retail and Car Park within Choi Ha Estate	21,438	205	108	3.9	0.07%	163	2.4%
Tuen Mun	Siu Lun Shopping Centre	32,022	463	299	13.5	0.26%	318	4.2%
Sheung Shui	Tin Ping Shopping Centre	61,722	471	532	25.2	0.48%	544	4.6%
Tseung Kwan O	Tsui Lam Shopping Centre	87,723	711	616	29.5	0.57%	650	4.5%
Total		**203,950**	**1,943**	**1,593**	**74**	**1.42%**	**1,716**	**4.3%**

3) Tender awarded on 27 Oct 2015, completed on 31 Dec 2015

District	Property name	Internal Floor area (sq ft)	Car-park spaces	Valuation as at 30 Sep 2015 (HKDm)	Net property income in FY15 (HKDm)	Net property income in FY15 (% of total portfolio)	Consideration (HKDm)	Implied yield# (%)
Chai Wan	Fung Wah Estate Retail and Car Park	9,821	161	97	3.1	0.05%	110	2.8%
Fanling	Ka Fuk Shopping Centre	59,053	312	456	19.8	0.35%	588	3.4%
Kwun Tong	Kwong Tin Shopping Centre	57,868	53	354	16.0	0.28%	407	3.9%
Tuen Mun	Siu On Court Retail and Car Park	17,084	273	82	2.9	0.05%	125	2.3%
Aberdeen	Tin Wan Shopping Centre	34,854	417	328	12.4	0.22%	486	2.5%
Total		**178,680**	**1,216**	**1,317**	**54.2**	**0.95%**	**1,716**	**3.2%**

4) Tender awarded on 31 Mar 2016, completion expected on 31 May 2016

District	Property name	Internal Floor area (sq ft)	Car-park spaces	Valuation as at 31 Mar 2016 (HKDm)	Net property income in 1H FY16 (HKDm)	Net property income in 1H FY16 (% of total portfolio)	Consideration (HKDm)	Implied yield**(%)
Tai Po	Wan Tau Tong Shopping Centre	54,464	438	746	17.5	0.6%	810	4.3%
Kwai Chung	Shek Yam Shopping Centre	75,270	424	719	15.1	0.5%	880	3.4%
Total		**129,734**	**862**	**1,465**	**32.5**	**1.1%**	**1,690**	**3.8%**

5) Tender awarded on 11 Apr 2016, completion expected on 31 May 2016

District	Property name	Internal Floor area (sq ft)	Car-park spaces	Valuation as at 31 Mar 2016 (HKDm)	Net property income in 1H FY16 (HKDm)	Net property income in 1H FY16 (% of total portfolio)	Consideration (HKDm)	Implied yield** (%)
Ma On Shan	Kam Ying Court Shopping Centre	37,260	492	411	8.5	0.3%	471	3.6%
Tuen Mun	Po Tin Shopping Centre	63,505	62	360	8.4	0.3%	438	3.8%
Wong Tai Sin	Tin Ma Court Comm Centre	37,900	585	264	4.7	0.2%	308	3.0%
Tai Wan	Retail and Car Park in Mei Chung Court	1,077	385	179	4.0	0.1%	204	3.9%
Fanling	Retail and Car Park in Yan Shing Court	11,810	252	135	2.7	0.1%	181	2.9%
Chai Wan	Hing Man Comm Centre	33,915	226	125	2.2	0.1%	209	2.1%
Tai Po	Retail and Car Park in Po Nga Court	13,951	246	120	2.4	0.1%	151	3.2%
		199,418	**2,248**	**1,595**	**32.9**	**1.1%**	**1,962**	**3.3%**

Source: Link REIT, Hong Kong Economic Times, Daiwa
*Note: *based on net property income in 1H FY14 (annualised) ^based on net property income in FY14, #based on net property income in FY15, **based on net property income in 1H FY16 (annualised)*

Importantly, Link REIT has pursued a strategy of using the sales proceeds to recycle capital (swapping into better-quality assets) and buy back shares at a discount, thereby offsetting the impact of the loss in rental income on DPU. We think its strategy of realising NAV and recycling capital conveys the following signals about the equity market valuations of the Hong Kong family property companies:

1) It illustrates that the book values and NAVs of the Hong Kong property companies are realisable. If anything, their book values and market estimates of their NAVs tend to have a conservative bias.

2) Using realised NAVs to buy back units/shares is a simple and equitable way of enhancing the per share value of the business.

Link REIT: unit buybacks since June 2014

Period	No. of units bought	Avg price (HKD)	Total amount (HKDm)	% of issued units
Jun 2014	1,927,000	41.87	81	0.083%
Aug 2014	1,773,500	45.89	81	0.077%
Sep 2014	14,757,000	46.10	680	0.639%
Dec 2014	1,472,000	47.88	70	0.064%
Jul 2015	8,314,000	45.29	377	0.363%
Aug 2015	28,271,500	43.36	1,226	1.239%
Sep 2015	4,313,500	41.54	179	0.191%
Dec 2015	3,119,500	46.01	144	0.139%
Feb 2016	3,500,500	43.27	151	0.156%
Mar 2016	2,700,000	44.41	120	0.120%
Total	**70,148,500**	**44.33**	**3,109**	**3.070%**

Source: HKEx, Daiwa

Large disconnect between physical market values and stock-market valuations

We note that the current implied values of the Hong Kong family property companies are well below their physical market values. The table shows the implied blended average prices for these companies' Hong Kong landbank alone (i.e., assuming zero value for all their China assets, stakes in listed companies, and all other businesses in Hong Kong, China and overseas). Still, the implied prices look like a fraction of the values they could command in the physical market. Effectively, it appears that, through the stock market, one could buy up nearly all of the most prime property assets in Hong Kong at per sf prices that would buy only industrial buildings in the physical market.

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 (as of 23 May, HKD)	86.95	45.25	44.45	11.40	19.90	41.35	USD6.08	14.22	31.60
Market cap (HKDm)	251,720	174,032	146,947	70,291	116,415	125,332	USD14,305	63,947	33,076
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)^	4,804	5,534	9,550	5,329	7,059	9,410	USD2,341	14,211	6,018
Implied value of HK landbank (HKD/sq ft)*	4,551	5,150	5,186	5,329	7,059	9,075	USD2,341	14,211	6,018
Gross rental income (HKDm)	19,681	8,500	8,054	3,684	10,800	11,200	8,850	7,962	3,432
Gross rental income/market cap	7.8%	4.9%	5.5%	5.2%	9.3%	8.9%	7.9%	12.5%	10.4%

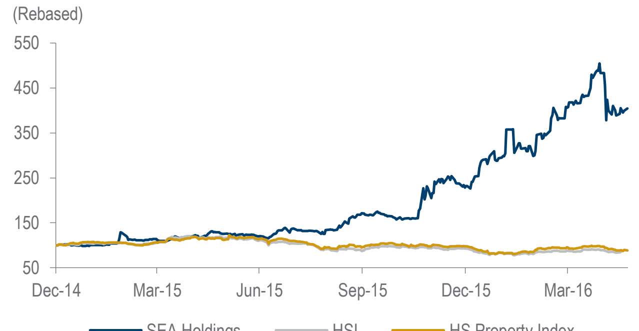
Source: Daiwa estimates
*Note: *excluding listed assets*
^market cap/sq ft of HK landbank, implying zero value for their non-HK property assets (including China assets, listed assets and all their other assets)

In terms of the size of this disconnect between physical market values and stock-market valuations, we think there are no parallels in global property. Commercial rationality should dictate that this situation won't last forever. It follows that if market participants do not capitalise upon this disconnect, sooner or later private equity capital, activists or regulators would do something about it.

Some property companies have already initiated corporate action to capitalise on the "Hong Kong discount" anomaly

In recent years, some of the smaller property companies look to have been capitalising on this "Hong Kong discount" anomaly. Shown below are the share prices of Chinese Estates (127 HK, HKD18.1, Not rated) and SEA Holdings (251 HK, HKD20.9, Not rated). While many investors probably have not heard of these names, their stock prices have outperformed the Hang Seng Index and the Hang Seng Property Index by substantial margins over the past 6 months (for SEA Holdings) and 24 months and past few years (for Chinese Estates).

SEA Holdings: relative share price performance vs HSI and HS Property Index since 2014

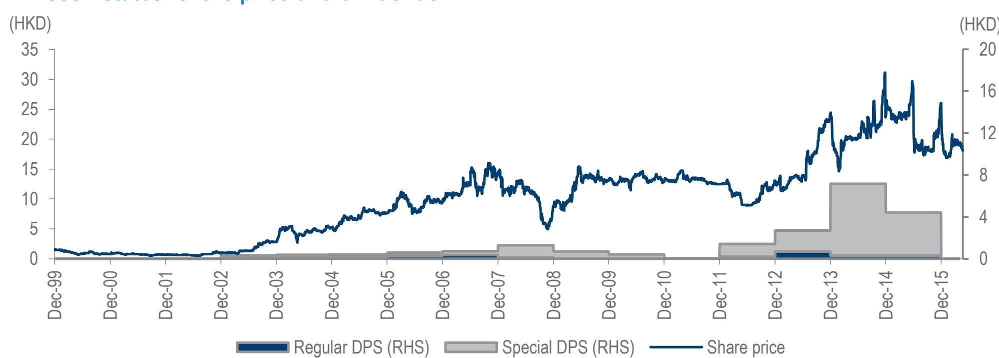


Source: Bloomberg, Daiwa

Chinese Estates: relative share price performance vs HSI and HS Property Index since 2014

Source: Bloomberg, Daiwa

Chinese Estates: share price and dividends



Source: Company, Bloomberg, Daiwa

Essentially, these companies have been capitalising on the disconnect between prices in the physical market and stock-market valuations. The case of SEA Holdings is the most straightforward, as it has paid a special dividend out of the sales proceeds raised from monetising the value of its physical properties, and supplemented this with share buybacks. It recently disposed of its Dah Sing Financial Centre in Wanchai to China Life for HKD10bn, and its share price performance in recent months likely reflects market expectations that it will declare a sizeable special dividend in the future.

Chinese Estates has done something similar, though it has done so asset by asset over a prolonged period. In its case, the major shareholder buys property assets from the company, and then the company uses the proceeds to declare a special dividend that benefits the major shareholder. In this context, the physical market values that the property companies can realise, and the size of the dividends they are prepared to pay out following such asset sales, should serve as an important support for their stock-market valuations, in our view.

Significant investment value could be unlocked if the Hong Kong discount were to narrow

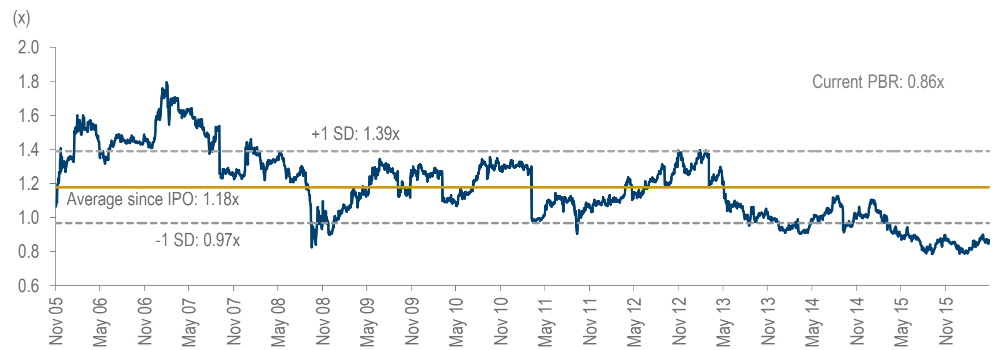
A big improvement in recurrent rental income does not appear to be reflected in share prices

Our view is that significant investment value can be unlocked, but only if the Hong Kong property companies are seen to be making strides in their dividend policies and capital management. As we have established, the business models of the Hong Kong property companies are changing, with many of them now having much larger recurrent income bases and being less exposed to volatility in residential property sales.

However, though many of the Hong Kong property companies have become more like landlords and REITs in terms of their earnings structure, they are still being priced like traditional residential developers. In other words, we believe the way their shares are being priced does not reflect the change in the companies' business models. In the meantime, Link REIT, which owns bottom-tier retail property assets in Hong Kong, is being priced at a valuation (since IPO in 2005, it traded at an average of 18% premium to book value.

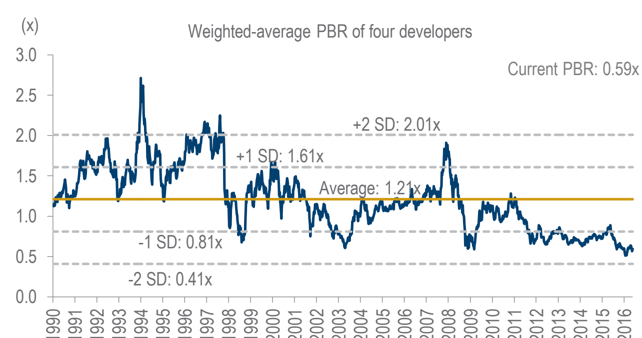
Although it is now trading at a 16% discount to its book value, the discount is still the lowest among property companies in Hong Kong) that has never been commanded by the major property companies, which suggests to us that the "Hong Kong discount" is not entirely due to the market's view of the underlying assets and the outlook for Hong Kong property. Another factor, in our view, is how these stocks are perceived by the global capital market, chiefly in terms of how confident investors are that the business values and financial strength of these companies will be reflected in the value of the shares. Hence, we consider dividend payments and capital management as presenting an opportunity for the Hong Kong property stocks to narrow their valuation discounts.

Link REIT: PBR trend since IPO



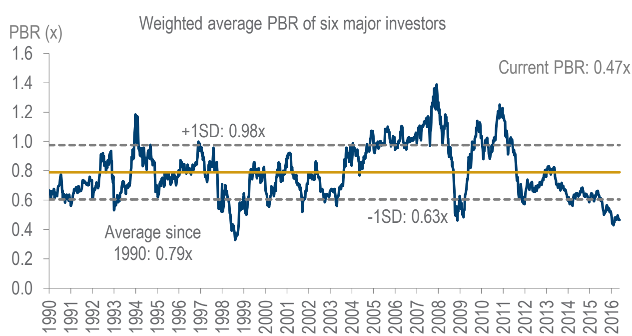
Source: Company, Bloomberg, Daiwa

Major Hong Kong property developers: PBR



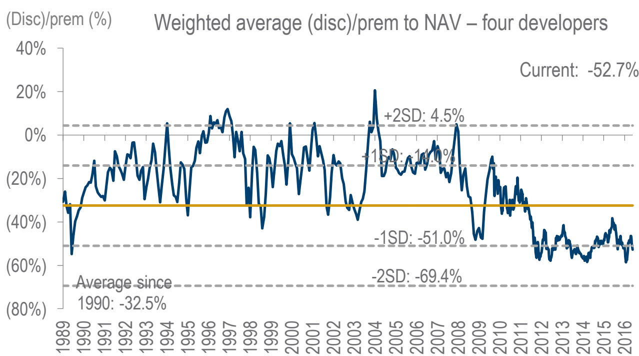
Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



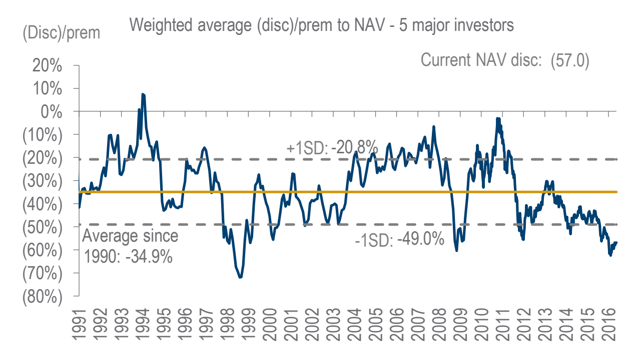
Source: Companies, Datastream, Daiwa

Major Hong Kong property developers: P/NAV



Source: Companies, Datastream, Daiwa estimates

Major Hong Kong property investors: P/NAV



Source: Companies, Datastream, Daiwa estimates

Up to USD100bn in investment value could be unlocked, on our estimates

We estimate that the market value of the assets owned by the listed real estate companies in Hong Kong exceeds USD400bn, whereas the listed real estate sector in Hong Kong has a market cap of around USD200bn. While we do not expect the discount to disappear altogether, just a 5-10bps reduction in the discount would translate into investment value of USD20-40bn. And that is before we take into account the fact that, over time, these

companies should have scope to grow their NAVs as they own some of the most prime commercial property assets in Hong Kong and China.

The market value of the listed real estate sector in Hong Kong is more than USD200bn below the value of the underlying assets

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	3,846	45.25	22.4	30.2	2,683	15.6
16 HK	SHK Properties	2,895	86.95	32.4	56.9	1,248	14.0
12 HK	Henderson Land	3,307	44.45	18.9	72.6	905	5.2
83 HK	Sino Land	6,166	11.40	9.0	54.1	2,832	4.2
20 HK	Wheelock	2,032	32.95	8.6	11.9	1,790	7.6
17 HK	New World	9,388	7.11	8.6	44.4	5,221	4.8
				100.0			**51.3**
Property Investors							
4 HK	Wharf	3,031	41.35	16.1	60.0	1,211	6.4
1972 HK	Swire Properties	5,850	19.90	15.0	82.0	1,053	2.7
HKL SP	HK Land	2,353	USD6.08	14.3	50.2	1,172	7.1
101 HK	Hang Lung Properties	4,497	14.22	8.2	55.2	2,017	3.7
14 HK	Hysan Development	1,047	31.60	4.3	41.6	611	2.5
683 HK	Kerry Properties	1,443	19.30	3.6	59.9	579	1.4
41 HK	Great Eagle	668	28.75	2.5	65.2	232	0.9
				64.0			**24.8**
REITs							
823 HK	Link REIT	2,243	46.40	13.4	0.2	2,239	13.4
87001 HK	Hui Xian REIT	5,399	3.10	2.6	48.2	2,799	1.3
2778 HK	Champion REIT	5,786	3.97	3.0	63.4	2,120	1.1
778 HK	Fortune REIT	1,893	8.56	2.1	28.0	1,363	1.5
1881 HK	Regal REIT	3,257	1.90	0.8	75.0	814	0.2
405 HK	Yue Xiu REIT	2,845	4.27	1.6	63.6	1,037	0.6
435 HK	Sunlight REIT	1,638	4.12	0.9	31.6	1,120	0.6
1426 HK	Spring REIT	1,125	3.29	0.5	36.2	718	0.3
808 HK	Prosperity REIT	1,446	2.98	0.6	19.4	1,166	0.4
				25.3			**19.4**
Niche property companies							
878 HK	Soundwill	283	9.90	0.4	69.8	86	0.1
173 HK	K Wah International	2,840	3.75	1.4	52.3	1,354	0.7
497 HK	CSI Properties	10,037	0.25	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	4.32	0.7	59.4	546	0.3
488 HK	Lai Sun Development	30,159	0.10	0.4	62.0	11,446	0.1
				3.4			**1.4**
				192.6			**96.9**

Source: Bloomberg, Daiwa
Note: prices as of close on 23 May 2016

As shown in the following tables, the market valuations of the Hong Kong property stocks already discount much of the investor concern and potential downside, such that it would take a near collapse of the physical market to make the prevailing valuations of the Hong Kong property stocks seem reasonable relative to global norms. Our view is that progress in dividend policies and capital management will help to unlock this value — and hence investors should pay close attention for signs of improvement on both fronts.

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 (as of 23 May, HKD)	86.95	45.25	44.45	11.40	19.90	41.35	USD6.08	14.22	31.60
Market cap (HKDm)	251,720	174,032	146,947	70,291	116,415	125,332	USD14,305	63,947	33,076
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)^	4,804	5,534	9,550	5,329	7,059	9,410	USD2,341	14,211	6,018
Implied value of HK landbank (HKD/sq ft)*	4,551	5,150	5,186	5,329	7,059	9,075	USD2,341	14,211	6,018
Gross rental income (HKDm)	19,681	8,500	8,054	3,684	10,800	11,200	8,850	7,962	3,432
Gross rental income/market cap	7.8%	4.9%	5.5%	5.2%	9.3%	8.9%	7.9%	12.5%	10.4%

Source: Daiwa estimates
*Note: *excluding listed assets*
^market cap/sq ft of HK landbank, implying zero value for their non-HK property assets (including China assets, listed assets and all their other assets)

Hong Kong property stocks: end-2016E NAV under different scenarios

	Base	Further decline in HK property prices*							
(HKD/share)	case	10%	20%	30%	40%	50%	60%	70%	80%
SHKP	188.0	167.6	152.5	137.4	122.2	107.1	91.9	76.8	61.7
Henderson	86.8	76.5	71.4	66.3	61.2	56.1	50.9	45.8	40.7
Sino Land	22.9	22.7	20.6	18.5	16.4	14.3	12.2	10.2	8.1
Wharf	105.8	91.7	84.4	77.1	69.8	62.6	55.3	48.0	40.7
Hang Lung Prop	39.5	34.6	32.4	30.3	28.1	25.9	23.8	21.6	19.5
Hongkong Land	USD12.1	USD10.7	USD9.7	USD8.8	USD7.8	USD6.8	USD5.9	USD4.9	USD3.9
Hysan	66.5	59.5	53.2	46.9	40.6	34.3	28.0	21.7	15.3
Swire Properties	43.8	38.5	34.6	30.8	26.9	23.0	19.2	15.3	11.5

Source: Daiwa forecasts
*Note: *across-the-boad in all segments*

Hong Kong property stocks: implied value of Hong Kong landbank under different NAV scenarios^

	Base	Further decline in HK property prices*							
(HKD/sq ft)	case	10%	20%	30%	40%	50%	60%	70%	80%
SHKP	10,389	9,261	8,425	7,589	6,752	5,916	5,080	4,244	3,408
Henderson	16,917	14,918	13,921	12,923	11,926	10,928	9,931	8,933	7,936
Sino Land	10,219	10,178	9,240	8,302	7,364	6,425	5,487	4,549	3,610
Wharf	24,058	20,864	19,205	17,547	15,889	14,230	12,572	10,914	9,255
Hang Lung Prop	27,253	23,829	22,340	20,852	19,363	17,875	16,386	14,898	13,409
Hongkong Land	36,473	32,074	29,181	26,287	23,394	20,501	17,608	14,715	11,822
Hysan	15,613	13,962	12,482	11,002	9,522	8,042	6,562	5,082	3,602
Swire Properties	15,526	13,645	12,278	10,910	9,543	8,176	6,809	5,441	4,074

Source: Daiwa forecasts
*Note: *across-the-boad in all segments*
^market cap/sq ft of HK landbank, implying zero value for their non-HK property assets (which include China assets, listed assets and all their other assets)

Hong Kong property stocks: Daiwa's 12-month target prices

Company	Code	Rating	Share price (23 May, HKD)	NAV / share (End-2016E, HKD)	Target NAV discount (%)	Target price (HKD)	Upside (%)	BVPS (reported, HKD)	PBR (x)
CK Property	1113 HK	Buy (1)	45.25	101.50	30%	71.00	56.9%	68.2	0.66
SHK Properties	16 HK	Buy (1)	86.95	188.00	30%	131.60	51.4%	157.5	0.55
Henderson Land	12 HK	Buy (1)	44.45	86.80	30%	60.80	36.8%	76.0	0.58
Sino Land	83 HK	OP (2)	11.40	21.60	40%	13.00	14.0%	19.6	0.58
Wharf	4 HK	Buy (1)	41.35	105.80	40%	63.50	53.6%	101.5	0.41
Hang Lung Prop	101 HK	Buy (1)	14.22	39.50	40%	23.70	66.7%	28.7	0.50
Hongkong Land	HKL SP	Buy (1)	USD6.08	USD12.10	30%	USD8.50	39.8%	USD12.19	0.50
Hysan	14 HK	Buy (1)	31.60	66.50	30%	46.60	47.5%	64.5	0.49
Swire Properties	1972 HK	Buy (1)	19.90	43.80	30%	30.70	54.3%	37.0	0.54
MTRC	66 HK	OP (2)	35.85	53.40(SOTP)	20%(SOTP)	42.70	19.1%	29.03	1.23

Source: Bloomberg, Daiwa forecasts
Note: When a report covers six or more subject companies, please see important disclosures for Daiwa Capital Markets Hong Kong Limited at http://www.daiwacm.com/hk/research_disclaimer.html or contact your investment representative or Daiwa Capital Markets Hong Kong Limited at Level 26, One Pacific Place, 88 Queensway, Hong Kong.

Finally, we believe that developments in the global capital market could pave the way for the "Hong Kong discount" to narrow. In this regard we highlight 2 contributing factors:

From August 2016, real estate is set to be treated as a separate asset class

First, Real Estate is set to become a standalone sector in the Global Industry Classification Standard (GICS) used by the global financial community, rather than being included in Financials as currently. 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 categorises all major public companies. Real Estate is set to become the 11th sector under GICS after close of business on 31 August 2016. Since GICS is used as a basis for S&P and MSCI market indices, this revision could 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 Financial stocks alone.

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

Now Code	Sector	Subcode	Industry Groups	After 31 August 2016 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 Carre Equipment & Services	35	3510	Health Carre 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	Telecommunication 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

Second, MSCI is likely to make an announcement in June 2016 regarding its plans on several matters, including the possible inclusion of A shares in the MSCI Emerging Market Index. While the challenges are many and well known, we note that China's State Administration of Foreign Exchange (SAFE) has sought to implement measures to address the 3 remaining concerns expressed by MSCI in its previous review, as reported in the Financial Times.

How SAFE has sought to address the 3 remaining concerns of MSCI

MSCI concern	Changes announced by SAFE
1. The quota allocation process (MSCI noted that "all investors said they needed sufficient flexibility and assurance to secure additional quota should the need arise.")	- Holders of QFII licences would no longer need to seek individual approval for quotas, but would be automatically awarded a quota of between USD20om and USD5bn depending on their assets under management. Permission would still be needed beyond the USD5bn cap.
2. Investors needed daily liquidity (ie, the ability to repatriate money immediately rather than being the subject of a capital lock-up)	Managers of open-ended mutual funds will now be able to redeem their investments on a daily, rather than weekly, basis. However, a separate cap, limiting monthly net repatriation to 20% of the size of their QFII assets at the end of the previous year, remains.
3. The beneficial ownership of investments	MSCI has commented that this issue would largely be resolved once previously announced regulatory changes to the Shanghai-HK Stock Connect are proven to work effectively.

Source: HKEx, Daiwa

Hong Kong property names could soon be viewed as an asset class through which to gain China exposure

It remains to be seen whether the MSCI's soon-to-be-announced stance will signal a speeding-up of the timetable for A shares to be included the MSCI Emerging Market Index. However, our view is that it would be a considerable time before investors were willing to take on a sizeable increase in the weighting of A shares and China corporations in their portfolios. Against this backdrop, we think it is conceivable that some global funds would consider getting their China weighting indirectly through non-China corporations that have material exposure to China. Indeed, some global funds already get their China exposure through the major listed luxury retail brands in Europe or multinationals with sizeable China operations.

Given that the Hong Kong family property companies can offer the dividends, asset backing and transparency related to Hong Kong assets and cash flow, as well as growing China exposure (particularly prime commercial properties in the largest cities), we think global funds could consider them to be a credible way to gain China weighting without subjecting the portfolio to too much China risk.

In any case, we contend that the Hong Kong family property companies' earnings structures and business models are evolving, as they derive a rising proportion of their earnings and NAVs coming from income-producing rental properties, while they are now more willing to pay dividends. If they can sustain dividend yields of 4.5% or more (financially speaking, many of them should be able to do so if their share prices do not move up from current levels) and deliver a 5-10% CAGR in DPS over the coming years, we believe they will draw more interest from property and income funds, as well as other types of investors.

In sum, the Hong Kong property stocks' current valuations are an anomaly globally speaking and we believe "the Hong Kong discount" could narrow going forward. Much now depends on whether the Hong Kong family property companies continue to improve in terms of disclosure, governance, dividend policy and capital management, in our view.

Hong Kong | Financials | 25 May 2016

Daiwa Capital Markets

Cheung Kong Property (1113 HK)

Target price: **HKD71.00**

Share price (23 May): **HKD45.25** | Up/downside: **+56.9%**

5 4 3 2 **1**

Buy (initiation)

Initiation: realising value — for all shareholders

- Profiting from early entry into key markets and CK group reorganisation
- Over HKD160bn set to be brought in over 2016-18E
- Retains a shareholder-oriented focus; initiating with a Buy (1)

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Investment case: We believe the pullback in Cheung Kong Property's (CKP) share price since its listing in June 2015 has not been driven by fundamental factors and hence presents a sound opportunity to buy the shares. In our view, CKP is well placed to draw increased attention from global funds and other investors over time, given the differentiated way the group has runs its property business has generated impressive returns for shareholders over 40-plus years. CKP looks on track to monetise its timely purchase of land in Hong Kong and China, which should see it raise over HKD160bn (over 90% of its market capitalisation) during 2016-18, while the Cheung Kong group reorganisation in early 2015 has provided it with much expanded resources and opportunities.

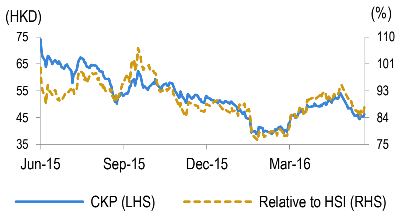
Notably, we believe Cheung Kong is one of the few business groups in Hong Kong, and possibly Asia, with a mindset of focusing on capital allocation and creating value for shareholders. In our opinion, the Cheung Kong group reorganisation and CKP's latest share buyback are important steps that are taking the company in a promising direction, ie, towards becoming a play on the theme of modernisation of capital management by family property companies/business groups in Hong Kong.

Catalysts: We flag 4 potential catalysts for CKP: 1) continued initiatives in creating value/returning value to shareholders, particularly the possibility of it carrying out potentially the largest share buyback in Hong Kong, 2) a strong ability to deliver earnings and dividends over the next few years, 3) potentially value-enhancing deals if it can effectively deploy the surplus capital that is returning to the company, and 4) progress in unlocking more value from the property assets of Hutchison, its hotel assets and others.

Valuation: In our opinion, CKP is more than just an undervalued property company. We think it has a special business model which has generated impressive returns for shareholders and believe it is entering a new chapter which will draw greater investor recognition over time. As such, we initiate coverage with a Buy (1) rating and 12-month TP of HKD71.0, based on a 30% discount to our end-2016E NAV of HKD101.50. We consider CKP a front-line play on the theme of the modernisation of property companies in Hong Kong and possibly Asia.

Risks: Other than the Hong Kong/China economy and property market, one risk we see is that the group's investment strategy may not necessarily fit well with the expectations of mainstream investors. That said, we think the group's track record supports our view that it has been savvy and prudent and has sought to create value for all shareholders.

Share price performance



12-month range	38.85-74.10
Market cap (USDbn)	22.41
3m avg daily turnover (USDm)	42.33
Shares outstanding (m)	3,847
Major shareholder	Li family & Trust (30.2%)

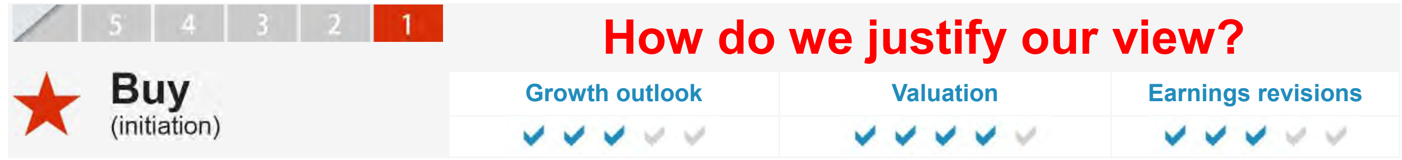
Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	63,132	69,779	76,635
Operating profit (m)	25,377	28,088	30,718
Net profit (m)	17,250	19,140	21,100
Core EPS (fully-diluted)	4.484	4.976	5.485
EPS change (%)	n.a.	11.0	10.2
Daiwa vs Cons. EPS (%)	(3.8)	4.3	10.3
PER (x)	10.1	9.1	8.2
Dividend yield (%)	3.4	3.9	4.3
DPS	1.550	1.750	1.950
PBR (x)	0.6	0.6	0.5
EV/EBITDA (x)	6.3	4.9	3.8
ROE (%)	6.3	6.6	6.8

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

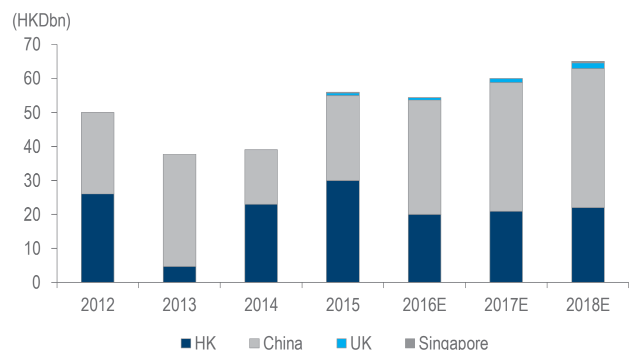
Company



Growth outlook

CKP's earnings outlook for 2016-18 is underpinned by a much expanded rental portfolio and the monetisation of its early entry into the land market in Hong Kong, China and London, which has been enhanced by the Cheung Kong group reorganisation. We forecast CKP will realise over HKD160bn in property sales over 2016-18, which would represent over 90% of its market cap and should underpin its earnings growth for the next 2-4 years. How well it deploys such capital would determine its earnings and NAV outlook over the next 3-8 years – CKP has a strong record of capital allocation, and just continuing to buy back its own shares would already represent an attractive and value-enhancing option, in our view.

CKP: achieved contract sales



Source: Company, Daiwa forecasts

Valuation

CKP has not escaped the "Hong Kong discount" and now trades at a 55% discount to our end-2016E NAV of HKD101.50, similar to its peers. However, we see CKP as potentially being a leading stock under any narrowing of the "Hong Kong discount" due to it being a pioneer in the modernisation of capital management, its sound earnings outlook over the next few years, as well as the option value associated with its ability to sustain its impressive track record of value creation for shareholders, now that it has a much enlarged asset, equity and recurrent income base.

CKP: Daiwa breakdown of estimated end-2016E NAV

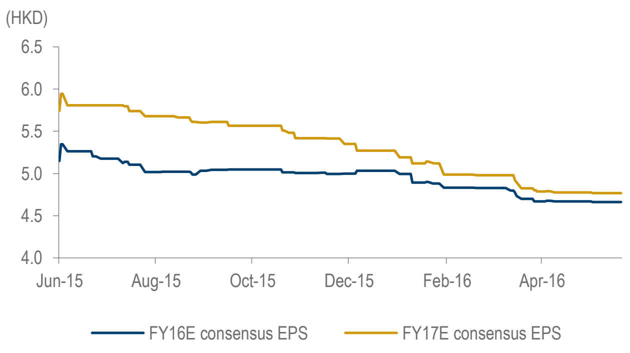
	Floor area (m sq ft)	Valuation Total (HKDm)	Per sq ft (HKD)	Per share (HKD)	No. of rooms	Value/ room (HKDm)
Investment properties						
HK	13.8	122,585	8,909	31.87		
China	1.8	5,140	2,927	1.34		
UK	0.08	304	3,850	0.08		
	15.6	**128,029**	**8,210**	**33.29**		
Development properties						
HK	6.92	65,356	9,448	16.99		
China	161.7	105,260	651	27.37		
Singapore	0.37	874	2,340	0.23		
UK	5.79	7,625	1,317	1.98		
	174.8	**179,115**	**1,025**	**46.57**		
Hotels & serviced suites						
HK	6.9	64,210	9,268	16.69	12,652	5.1
China	1.4	1,710	1,206	0.44	1,603	1.1
Bahamas	1.0	445	433	0.12	1,271	0.3
	9.4	**66,365**	**7,080**	**17.3**	**15,526**	**4.3**
GAV - all property assets	**199.8**	**373,508**	**1,870**	**97.1**		
Interests in listed REITs & ARA		11,485		3.0		
Net cash		5,238		1.36		
NAV		**390,232**		**101.5**		

Source: Daiwa

Earnings revisions

Our EPS forecasts for 2017-18, which are 4-10% above those of the Bloomberg consensus, look attainable given the company has a low-cost landbank in all markets, a much strengthened rental income base and China landbank; and our view that its property sales in China are progressing on a promising track. Our forecasts do not take into account any additional contributions related to astute deployment of the abundant cash that is returning to the company, or any disposal/revitalisation of the rental properties formerly owned by Hutchison. Nor have we factored in any effects from potential share buybacks, which would readily enhance its EPS and DPS. In our view, these are potential drivers of positive revisions to the market's forecasts for CKP.

CKP: revisions to consensus EPS forecasts



Source: Bloomberg, Daiwa

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales revenue (HKDm)	n.a.	n.a.	n.a.	26,348	49,059	50,585	56,494	62,690
Gross rental income (HKDm)	n.a.	n.a.	n.a.	2,331	5,138	7,541	7,818	8,159
Hotel and serviced suites revenue (HKDm)	n.a.	n.a.	n.a.	2,895	4,005	4,326	4,722	4,992

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales revenue	n.a.	n.a.	n.a.	26,348	49,059	50,585	56,494	62,690
Gross rental income	n.a.	n.a.	n.a.	2,331	5,138	7,541	7,818	8,159
Other Revenue	n.a.	n.a.	n.a.	3,548	4,596	5,007	5,467	5,786
Total Revenue	**n.a.**	**n.a.**	**n.a.**	**32,227**	**58,793**	**63,132**	**69,779**	**76,635**
Other income	n.a.	n.a.	n.a.	537	500	898	966	1,027
COGS	n.a.	n.a.	n.a.	(12,985)	(32,587)	(35,354)	(39,077)	(42,915)
SG&A	n.a.	n.a.	n.a.	(6,944)	(4,127)	(2,731)	(2,972)	(3,377)
Other op.expenses	n.a.	n.a.	n.a.	(286)	(508)	(569)	(609)	(651)
Operating profit	**n.a.**	**n.a.**	**n.a.**	**12,549**	**22,071**	**25,377**	**28,088**	**30,718**
Net-interest inc./(exp.)	n.a.	n.a.	n.a.	(815)	(549)	(464)	(346)	(248)
Assoc/forex/extraord./others	n.a.	n.a.	n.a.	2,878	1,409	0	0	0
Pre-tax profit	**n.a.**	**n.a.**	**n.a.**	**14,612**	**22,931**	**24,913**	**27,742**	**30,470**
Tax	n.a.	n.a.	n.a.	(2,313)	(6,568)	(6,851)	(7,768)	(8,532)
Min. int./pref. div./others	n.a.	n.a.	n.a.	(248)	(795)	(812)	(834)	(838)
Net profit (reported)	**n.a.**	**n.a.**	**n.a.**	**12,051**	**15,568**	**17,250**	**19,140**	**21,100**
Net profit (adjusted)	**n.a.**	**n.a.**	**n.a.**	**12,051**	**15,568**	**17,250**	**19,140**	**21,100**
EPS (reported)(HKD)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**4.484**	**4.976**	**5.485**
EPS (adjusted)(HKD)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**4.484**	**4.976**	**5.485**
EPS (adjusted fully-diluted)(HKD)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**4.484**	**4.976**	**5.485**
DPS (HKD)	**n.a.**	**n.a.**	**n.a.**	**0.000**	**1.400**	**1.550**	**1.750**	**1.950**
EBIT	**n.a.**	**n.a.**	**n.a.**	**12,549**	**22,071**	**25,377**	**28,088**	**30,718**
EBITDA	**n.a.**	**n.a.**	**n.a.**	**12,835**	**22,579**	**25,946**	**28,697**	**31,369**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	n.a.	n.a.	n.a.	14,612	22,931	24,913	27,742	30,470
Depreciation and amortisation	n.a.	n.a.	n.a.	286	508	569	609	651
Tax paid	n.a.	n.a.	n.a.	(975)	(3,866)	(6,851)	(7,768)	(8,532)
Change in working capital	n.a.	n.a.	n.a.	6,993	6,787	17,296	18,591	19,987
Other operational CF items	n.a.	n.a.	n.a.	(7,292)	(8,442)	443	330	236
Cash flow from operations	**n.a.**	**n.a.**	**n.a.**	**13,624**	**17,918**	**36,370**	**39,504**	**42,813**
Capex	n.a.	n.a.	n.a.	(296)	(483)	(7,995)	(10,008)	(11,024)
Net (acquisitions)/disposals	n.a.	n.a.	n.a.	3,298	3,216	0	0	0
Other investing CF items	n.a.	n.a.	n.a.	124	6,030	0	0	0
Cash flow from investing	**n.a.**	**n.a.**	**n.a.**	**3,126**	**8,763**	**(7,995)**	**(10,008)**	**(11,024)**
Change in debt	n.a.	n.a.	n.a.	(9,194)	45,951	0	0	0
Net share issues/(repurchases)	n.a.	n.a.	n.a.	0	0	(632)	0	0
Dividends paid	n.a.	n.a.	n.a.	(5,861)	(33,266)	(5,834)	(6,440)	(7,216)
Other financing CF items	n.a.	n.a.	n.a.	(1,410)	(4,337)	(1,223)	(1,284)	(1,349)
Cash flow from financing	**n.a.**	**n.a.**	**n.a.**	**(16,465)**	**8,348**	**(7,689)**	**(7,724)**	**(8,565)**
Forex effect/others	n.a.	n.a.	n.a.	0	0	0	0	0
Change in cash	**n.a.**	**n.a.**	**n.a.**	**285**	**35,029**	**20,685**	**21,772**	**23,224**
Free cash flow	n.a.	n.a.	n.a.	13,328	17,435	28,375	29,496	31,789

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	n.a.	n.a.	n.a.	10,354	45,861	60,688	72,780	86,005
Inventory	n.a.	n.a.	n.a.	73,259	153,301	147,009	139,944	133,549
Accounts receivable	n.a.	n.a.	n.a.	1,810	12,335	12,860	13,125	13,360
Other current assets	n.a.	n.a.	n.a.	1,210	0	0	0	0
Total current assets	**n.a.**	**n.a.**	**n.a.**	**86,633**	**211,497**	**220,557**	**225,849**	**232,914**
Fixed assets	n.a.	n.a.	n.a.	9,928	18,614	18,690	18,723	18,708
Goodwill & intangibles	n.a.	n.a.	n.a.	0	0	0	0	0
Other non-current assets	n.a.	n.a.	n.a.	86,655	141,694	146,045	150,910	155,864
Total assets	**n.a.**	**n.a.**	**n.a.**	**183,216**	**371,805**	**385,292**	**395,482**	**407,486**
Short-term debt	n.a.	n.a.	n.a.	250	5,772	0	0	0
Accounts payable	n.a.	n.a.	n.a.	4,502	14,785	15,215	15,620	15,820
Other current liabilities	n.a.	n.a.	n.a.	78,044	16,070	17,018	17,375	17,786
Total current liabilities	**n.a.**	**n.a.**	**n.a.**	**82,796**	**36,627**	**32,233**	**32,995**	**33,606**
Long-term debt	n.a.	n.a.	n.a.	350	55,217	55,450	45,450	35,450
Other non-current liabilities	n.a.	n.a.	n.a.	999	10,274	10,415	10,544	10,626
Total liabilities	**n.a.**	**n.a.**	**n.a.**	**84,145**	**102,118**	**98,098**	**88,989**	**79,682**
Share capital	n.a.	n.a.	n.a.	0	3,860	3,860	3,860	3,860
Reserves/R.E./others	n.a.	n.a.	n.a.	96,254	259,236	276,479	295,610	316,699
Shareholders' equity	**n.a.**	**n.a.**	**n.a.**	**96,254**	**263,096**	**280,339**	**299,470**	**320,559**
Minority interests	n.a.	n.a.	n.a.	2,817	6,591	6,856	7,023	7,245
Total equity & liabilities	**n.a.**	**n.a.**	**n.a.**	**183,216**	**371,805**	**385,293**	**395,482**	**407,486**
EV	n.a.	n.a.	n.a.	121,227	183,644	163,203	140,948	117,641
Net debt/(cash)	**n.a.**	**n.a.**	**n.a.**	**(9,754)**	**15,128**	**(5,238)**	**(27,330)**	**(50,555)**
BVPS (HKD)	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**72.879**	**77.852**	**83.335**

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	n.a.	n.a.	n.a.	n.a.	82.4	7.4	10.5	9.8
EBITDA (YoY)	n.a.	n.a.	n.a.	n.a.	75.9	14.9	10.6	9.3
Operating profit (YoY)	n.a.	n.a.	n.a.	n.a.	75.9	15.0	10.7	9.4
Net profit (YoY)	n.a.	n.a.	n.a.	n.a.	29.2	10.8	11.0	10.2
Core EPS (fully-diluted) (YoY)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11.0	10.2
Gross-profit margin	n.a.	n.a.	n.a.	59.7	44.6	44.0	44.0	44.0
EBITDA margin	n.a.	n.a.	n.a.	39.8	38.4	41.1	41.1	40.9
Operating-profit margin	n.a.	n.a.	n.a.	38.9	37.5	40.2	40.3	40.1
Net profit margin	n.a.	n.a.	n.a.	37.4	26.5	27.3	27.4	27.5
ROAE	n.a.	n.a.	n.a.	25.0	8.7	6.3	6.6	6.8
ROAA	n.a.	n.a.	n.a.	13.2	5.6	4.6	4.9	5.3
ROCE	n.a.	n.a.	n.a.	25.2	10.3	7.5	8.1	8.6
ROIC	n.a.	n.a.	n.a.	23.7	8.4	6.5	7.2	7.9
Net debt to equity	n.a.	n.a.	n.a.	n.a.	5.8	n.a.	n.a.	n.a.
Effective tax rate	n.a.	n.a.	n.a.	15.8	28.6	27.5	28.0	28.0
Accounts receivable (days)	n.a.	n.a.	n.a.	10.2	43.9	72.8	68.0	63.1
Current ratio (x)	n.a.	n.a.	n.a.	1.0	5.8	6.8	6.8	6.9
Net interest cover (x)	n.a.	n.a.	n.a.	15.4	40.2	54.7	81.2	123.9
Net dividend payout	n.a.	n.a.	n.a.	n.a.	n.a.	34.6	35.2	35.5
Free cash flow yield	n.a.	n.a.	n.a.	7.7	10.0	16.3	16.9	18.3

Source: FactSet, Daiwa forecasts

Company profile

Cheung Kong Property (CKP) is a new entity created by the Cheung Kong Group reorganisation announced on 9 January 2015, which, among other things, resulted in the creation of 2 separate companies for the global capital markets: one a global conglomerate named Cheung Kong Hutchison, and the other a pure property company, namely CKP. The company was listed on the Hong Kong Stock Exchange on June 2015 by way of introduction. CKP is currently one of the largest property companies in Hong Kong, with a 14m sq ft rental portfolio, 212m sq ft of development landbank, and some 12,625 hotel rooms in Hong Kong, China and overseas.

Share pullback post IPO presents sound buying opportunity

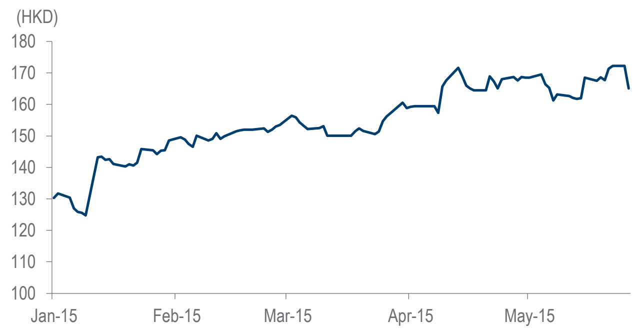
CKP was created as a result of an unusual corporate reorganisation

CKP was listed on the Hong Kong Stock Exchange in June 2015 by way of introduction, through Cheung Kong Hutchison's (1 HK, HKD88.15, Buy [1]) distribution of its property business to all shareholders. Cheung Kong Hutchison, in turn, was a new entity created by the Cheung Kong group reorganisation announced on 9 January 2015, which, among other things, resulted in the creation of 2 separate companies for the global capital markets: one a global conglomerate named Cheung Kong Hutchison, and the other a pure property company, namely Cheung Kong Property.

In our opinion, this Cheung Kong group reorganisation was a landmark event for corporate Hong Kong. While there are many different interpretations of the reorganisation, we view it as the first declaration made by a major family business group in Hong Kong, and perhaps Asia, to show a concerted attempt to become a truly premier global company, and for it to be recognised and valued by the capital markets as such (see our special report: Cheung Kong/Hutch's Bold Move, 9 February 2015).

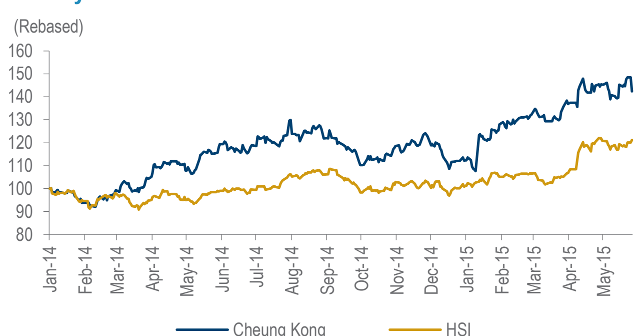
Such a move is unprecedented in the Hong Kong corporate sector. In our view, it was an ambitious and aspirational undertaking that represents a major step forward in how the family business groups in Hong Kong, or Asia, position themselves in the global capital markets in the future. The initial response from the stock market to this reorganisation was very positive, as reflected in the surge in Cheung Kong Holding's relative share price performance in the run-up to its actual distribution and listing of CKP shares in June 2015.

Cheung Kong (Holdings): share-price performance from January 2015 to June 2015



Source: Bloomberg

Cheung Kong (Holdings): share-price performance vs. HSI from January 2014 to June 2015



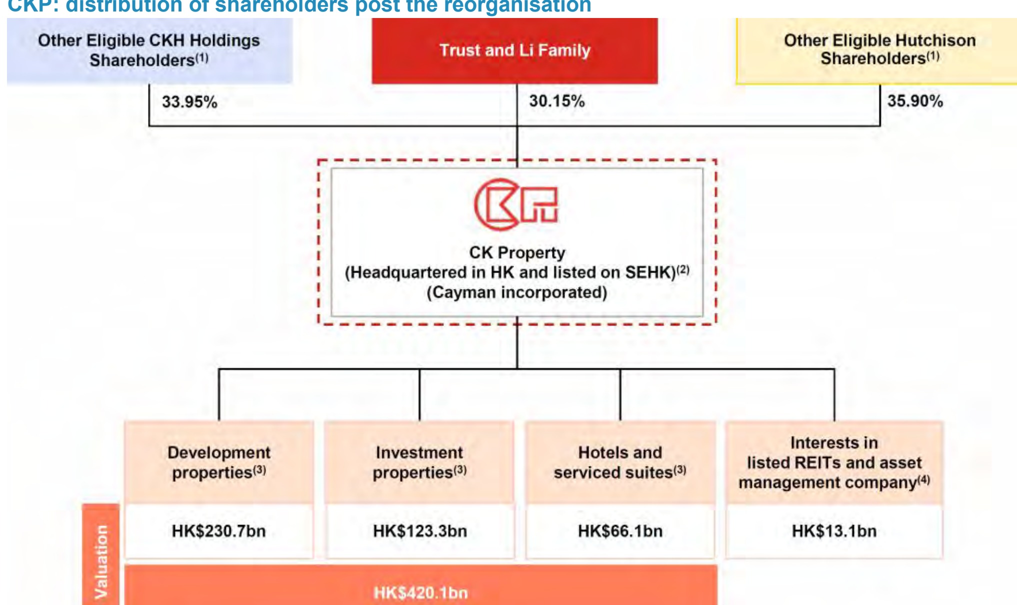
Source: Bloomberg, Daiwa

The initial enthusiasm the market showed for the Cheung Kong group reorganisation was something of a "double-edged sword"

However, in retrospect, the initial enthusiasm the market showed for the Cheung Kong group reorganisation might have been a double-edged sword. For while on the one hand the reorganisation boosted investor awareness of the separate listing of CKP 6 months later, the caveat was that some investors who wanted to own CKP could have bought Cheung Kong Hutchison shares first and then waited for the distribution of CKP shares as dividends. In this light, the reorganisation could have had the effect of front-loading the demand for CKP shares into the share performance of the Cheung Kong group before the distribution could be made in June 2015.

Another feature of this reshuffle was that it resulted in the original Hutchison shareholders ending up owning considerable numbers of CKP shares. However, the nature and scope of the businesses of Hutchison and Cheung Kong are very different, and hence investors who were originally Hutchison shareholders may not want to hold a property company for long.

CKP: distribution of shareholders post the reorganisation



Source: Company

Note: 1. Certain non-qualifying overseas shareholders will not receive CKH Holdings shares and/ or CK Property shares

2. After completion of the listing

3. Property valuation as at 28 February 2015

4. Assuming aggregate attributable market value based on the Group's attributable interests as at 8 May 2015 (32.3% stake in Hui Xi'an REIT, 28.0% stake in Fortune REIT, 19.3% stake in Prosperity REIT and 7.8% stake in ARA Asset Management) and market data as at 8 May 2015 closing. As at 8 May 2015, the Group's ownership interest in Hui Xian REIT was c.46.0%, including c.28.2% stake held by Hui Xi'an Holdings Limited, which was c.33.4% held by Cheung Kong and c.17.9% held by Hutchison respectively

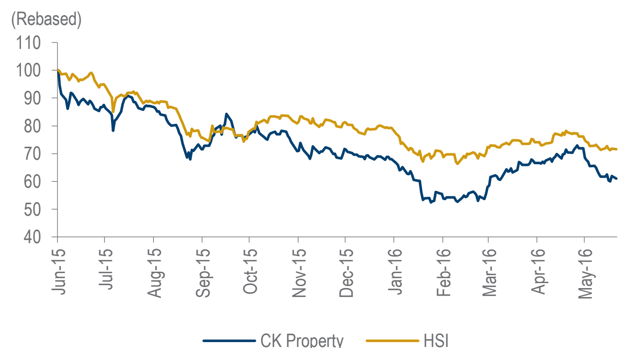
CKP shares were the subject of technical selling in the initial period since their debut

As such, our observation is that as at June 2015, quite a number of CKP shares were in the hands of investors who were originally Hutchison shareholders, and who may not have wanted any exposure to property. In this sense, the strong share performances of Cheung Kong and Hutchison prior to June 2015 might have made the challenge even greater for CKP shares in the initial period, in that the strong share price performance of Cheung Kong in 1H15 significantly boosted unrealised gains on the book for investors who had entered into the stocks early (especially those who owned the shares before or shortly after the reorganisation was announced in January 2015).

CKP: share-price performance since June 2015

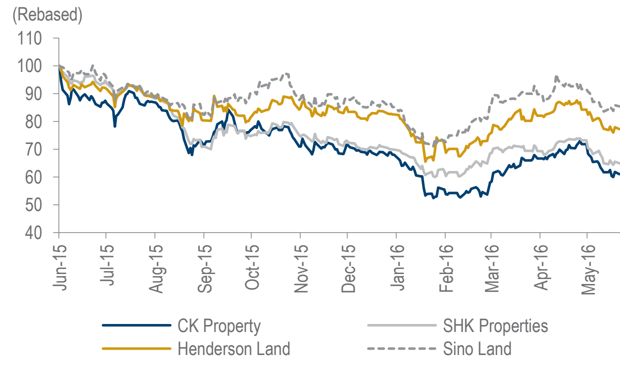
Source: Bloomberg

CKP: share-price performance vs. HSI since June 2015



Source: Bloomberg, Daiwa

Share-price performance vs. peers since June 2015



Source: Bloomberg, Daiwa

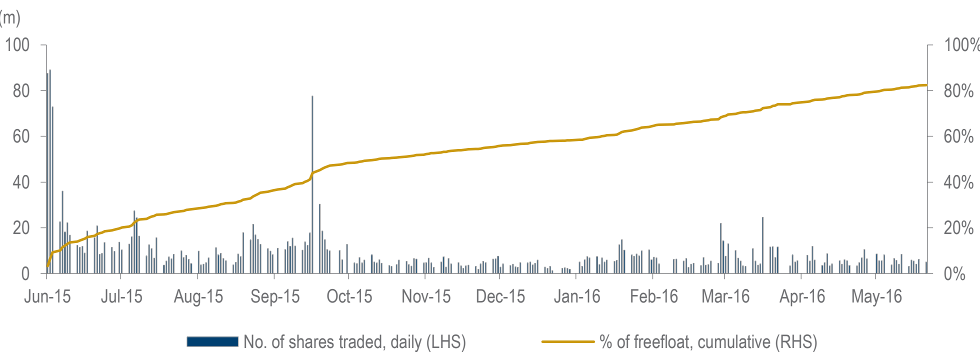
Meanwhile, these challenges faced by CKP were compounded by the fact that the global capital markets turned negative on China and Hong Kong in 2H15. This heightened the selling pressure on CKP shares in the initial period, and in our view, is one reason for the weak relative share-price performance of CKP since its debut.

We think the share-price weakness of CKP since listing in June 2015 is due more to technical factors than fundamentals

That said, if the above interpretation is correct, then the share price weakness of CKP since its listing in June 2015 was due more to technical than fundamental factors. While the stock market has responded positively to the Cheung Kong group reorganisation, our read is that the market seems to have focused mainly on its immediate effects, rather than the symbolic messages on the longer-term strategy and direction of the group, which we see as the most important part of the deal for investors.

We note that the average trading volume of CKP shares has been 9.4m shares per day since its debut in June 2015, and we estimate that the number of its shares being traded in the market since its listing now totals over 80% of its public free float. While there must be investors who have changed their shares several times during this period, our view is that a considerable amount of the initial selling pressure on the stock should have now dissipated, and the situation will only improve over time. As such, we believe the technical selling of CKP shares, if not yet over, should not be far from that point, and hence see the weak relative share-price performance of CKP in recent months as a good buying opportunity for longer-term oriented investors.

Trading of CKP shares since their listing in June 2015



Source: Bloomberg, Daiwa

Overall, we see CKP as an interesting and important addition to the family of global property stocks and we expect its importance to property funds and other global investors to increase over time. We thus initiate coverage of CKP with a Buy (1) rating and 12-month target price of HKD71.0/share, based on a 30% discount applied to our end-2016E NAV of HKD101.50. For the following reasons, we believe now is a sound opportunity for investors to buy into CKP:

1) CKP has been an impressive capital allocation and financial returns generating machine in the past.
2) We see a major harvesting time ahead, with over HKD160bn (HKD41.60/share or over 90% of its current market capitalisation) to be raised in property sales revenue from its low cost landbank in Hong Kong China over 2016-18.
3) New capital deployment and value realisation of Hutchison Property and others would provide room for further earnings/share-price upside.
4) More share buybacks is a legitimate and available option – CKP has taken a first step in this area and could potentially launch the largest share buyback scheme and return the most value to shareholders of any major property company in Hong Kong and possibly Asia.
5) Valuation – we see considerable scope for a narrowing of its NAV discount.

We elaborate on each of these points in the remaining sections of this report.

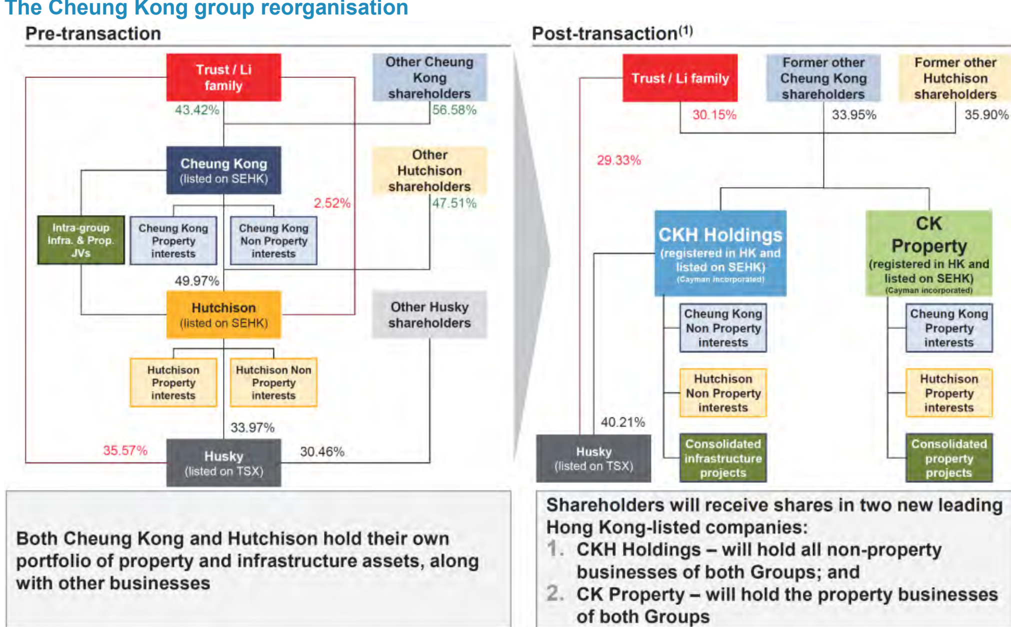
1. Return-generating machine

A property company that is a business-builder and investor at heart

We believe the Cheung Kong group is an investor at heart

While CKP and CK Hutchison are now 2 separately listed companies, we think they share something in common, namely that CKP was under CK Hutchison prior to its separate listing in June 2015 and both companies are still owned and run by the same family (the Li family). Compared with other business groups in Hong Kong or Asia, Cheung Kong Hutchison group is different in terms of the diversity and geographical spread of its businesses. Indeed, Cheung Kong Hutchison now operates a variety of businesses in over 50 countries and ranks as one of the world's largest players in several of these businesses, which is unusual among business groups in Hong Kong, and even perhaps Asia.

The Cheung Kong group reorganisation



Source: Company

Note: (1) Calculated based on the average closing price of Cheung Kong and Hutchison shares for the 5 trading days up to and including 7 January 2015 and the average closing price of Husky for the 5 trading days up to and including 6 January 2015

Importantly, while the Cheung Kong Hutchison Group's business portfolio and geographical presence are diverse, the philosophy behind the development of these businesses looks similar to us. Indeed, our read is that there is a remarkable continuity in the Cheung Kong Hutchison Group's evolution, from a manufacturer in the beginning, to a Hong Kong property company since the 1960s, then a Hong Kong conglomerate from the 1980s onwards; and then a global conglomerate from the mid-1990s onward. We believe, too, that there is a remarkable similarity in the way it runs and manages its various businesses.

Secures a favourable entry point, and then builds scale so that the gains "snowball"

Nevertheless, we will leave a discussion about the Cheung Kong group's distinct approach to business building and investing to a separate thought piece. Suffice it to say, we believe the Cheung Kong Hutchison group is a business builder and investor at heart in that it has an unusual investor and capital allocation mindset when it comes to the investment, building and management of its businesses. In our view, one major tenet of the Cheung Kong group's business model is to secure an attractive entry point in the early stage of some growth industries, and then "snowball" the returns through continuously expanding its market position and scale of operation in respective industries over time.

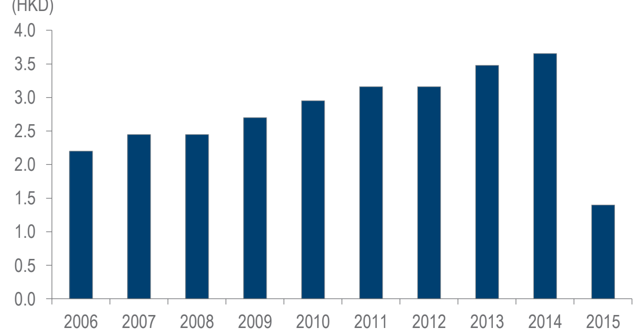
Importantly, we think the same strategy has been applied to the development of Cheung Kong's property businesses. Indeed, one might ponder whether a major force shaping the Cheung Kong Hutchison group's business philosophy was its origin as a property developer in Hong Kong from the 1960s onwards. In any case, we think it is important to

highlight that while CKP is technically a new company with less than 1 year of history, beyond that is over 4 decades of experience in running a property business, which generated impressive returns to shareholders while not having exposed shareholders to significant risks during any particular point throughout these years (which included some of the most turbulent periods a property market could experience).

Impressive track record in terms of capital allocation and recycling

Outlined in Appendix 1 is a sketch of the evolution of Cheung Kong group's property business over the past few decades – an evolution that has been characterised by a continuous recycling of capital. Our view is that the company has now passed through 3 chapters; and one of its most important achievements in its Chapter 3 (2003-15) was that while remaining one of the largest residential property developers in Hong Kong's highly capital-intensive residential property industry, it has managed to build up a sizeable presence in China property as well as in 3 niche sectors (Hong Kong hotels and serviced suites, as well as property businesses in the UK and Singapore), all the while growing its dividends and reducing its net gearing ratio, and with no equity capital raising for 20 years.

CKP/Cheung Kong: DPS record for the past 10 years



Source: Company,

CKP/Cheung Kong net gearing ratio for the past 10 years

Source: Company

Evolution of Cheung Kong's property business and its continuous recycling of capital

Period	Theme	Where it invested its capital and how the investments were financed
Chapter 1 (1960s-1990)	An ambitious push forward as a HK developer	Issued shares to finance joint-ventures with entities that owned land but lacked property development expertise
		Acquired the old British companies that owned a lot of land and were trading at major discounts to their NAVs
		Used the landbank resources of its acquired companies to embark on the development of 4 mega projects, namely, Serenity Garden, Laguna City, South Horizons and Kingswood Villa.
Chapter 2 (1991-2003)	Focusing more on revitalising Hutchison and then leveraging on Hutchison to achieve further growth	Channelled profits raised from residential property developments into funding the recapitalisation of Hutchison in the early 1990s
		Joined with Hutchison to expand its Hong Kong residential landbank after the correction in 2Q94-4Q95
		Used the strong and growing dividends from Hutchison to build up Cheung Kong Infrastructure (CKI) and its hotel/serviced suites business, together with gaining an initial presence in Singapore and UK property
		Monetised the value of CKI through the Cheung Kong group restructuring in 1997 (swapping its stake in CKI for more Hutchison shares and HKD5bn cash)
Chapter 3 (2004-2014)	Making a major push forward as a Hong Kong residential developer and building up its China presence	Started significantly scaling up its Hong Kong residential landbank in 2004
		Built up a sizeable landbank in China during the 2004-07 time window
		Started realising the value of its early investments in land in Hong Kong and China .
		Used surplus cash to invest in infrastructure projects and an aircraft leasing business
Chapter 4 (2015 onwards)	Transformed into a developer with balanced exposure to property investment and development as well as a much enhanced scale of operation.	One way to interpret the Cheung Kong group reorganisation is that it allowed the merger of Cheung Kong Property and Hutchison Property which has led to the creation of a larger and stronger property group
		Realising the value of its investments for land in China and Hong Kong
		Waiting for opportunities to replenish landbank; using surplus cash to pay higher dividends and/or undertake share buybacks
		Looking at M&A opportunities in the property space in multi-markets

Source: Company annual reports, Hong Kong Economic Times, SCMP, Daiwa

Impressive machine in terms of generating financial returns to shareholders

At the end of 1999, Cheung Kong's ex-Hutchison book value stood at HKD34.6bn, which had risen 5x to HKD177.3bn by the end of 2014, representing a CAGR of 11.5% in 15 years. Note that Cheung Kong did not raise any new equity during the period. Nor did its book value benefit from substantial revaluation gains, as all along the focus of the Cheung Kong group has been more on capital recycling, and it does not own many rental properties. Note also that Cheung Kong's book value reflects its development properties at

cost and all its hotel and serviced suites at cost minus cumulative depreciation. Were we just to change its hotel assets back to market value, the CAGR for its book value during this 15 years would have been 15.4%. Were we to value its Hong Kong China landbank at market value, then we estimate its book value per share would have risen at a CAGR of about 20% over those 15 years.

In terms of ex-Hutchison earnings per share, we estimate the CAGR achieved by Cheung Kong from end-1999 to end-2004 was also 15.3% even though this period included some of the worst years in Hong Kong property. In the meantime, the Cheung Kong group kept on raising its DPS over the past 10 years and the group never found itself to be financially vulnerable during this period, notwithstanding all the turbulence in the Hong Kong economy and property markets. In all, from the standpoint of shareholders, CKP has achieved impressive financial returns while keeping risk well under control, in our view.

The Cheung Kong model; early entry, scale, cost-control, and capital recycling

In our opinion, early entry into the markets, cost-control & scale economies, as well as continuous capital recycling are major factors which have contributed to the impressive financial returns CKP achieved for shareholders during 2000-15.

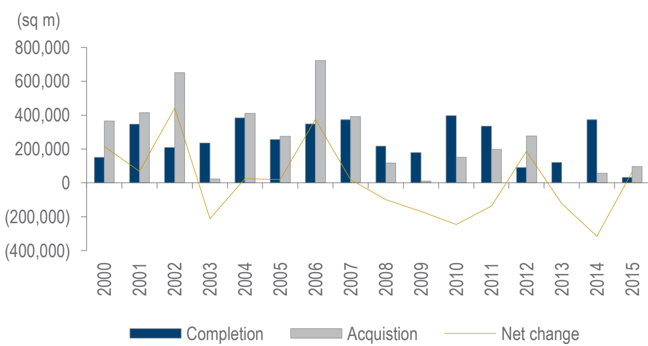
Decisive and timely in scaling up its landbank in both Hong Kong and China

In retrospect, probably the most important factor that has underpinned CKP's development during 2003-15 was the decisive action it took in terms of expanding its residential landbank in Hong Kong and China in a major way during the early phase of the cycle when overall market sentiment was still weak in the midst of the prevailing uncertainty at the time. In hindsight, CKP timed the boosting of its residential landbank in Hong Kong very well – it managed to seize the opportunity to buy a sizeable 2.7m sq ft GFA site in Tiu Keng Leng, Tseung Kwan O in November 2002 just before land auctions were suspended. When land auctions resumed in 2004, Cheung Kong was the most active in bidding, and it remained an active net buyer of land in Hong Kong during 2004-06.

In hindsight, one interesting and illustrative case to note was the determination shown by Cheung Kong to get the large residential site in Homantin in October 2004 (later developed into a luxury development known as Celestial Heights). The price it paid (HKD9.4bn, or HKD5,476/sq ft in AV) was significantly above market expectations, and it was widely seen by commentators at that time that Cheung Kong had paid a price that would not allow it to make any profits.

However, it later turned out that Cheung Kong included a large number of 4-bedroom units in this project (which were scarce in the Kowloon area and Homantin District) and successfully marketed the project as a luxury residential development, eventually achieving over a 40% profit margin from its sales. For shareholders, this investment was worthwhile and we think illustrates that the group has its own way of analysing and assessing the property market, and has been prepared to make sizeable investments to back up its view, even when it is a contrarian perspective.

CKP/Cheung Kong: annual land purchases, completion of property development businesses in Hong Kong



Source: Company, Daiwa estimates

CKP/Cheung Kong: cumulative change in residential landbank in Hong Kong

Source: Company, Daiwa estimates

Strategy focuses as much on timing land purchases as the design and building of units

In our opinion, the rapid surge in the size of CKP's Hong Kong landbank during 2004-06 is an important point to note, because we believe it highlights one major feature of the Cheung Kong way of running a property business. While most developers tend to focus mainly on the profitability of each property project, the CKP model seems to place a lot more emphasis on its overall landbank position relative to the stage of development of the cycle. In retrospect, CKP's developments during 2004-06 were characterised by both heavy completion volume but even heavier land purchases.

We think one consequence of this combination is that it allowed the company to rapidly expand its landbank size without having to tie up significant amounts of capital. Note that for the same dollar amount of investment tied up in completed units and land, the GFA – and hence the company's exposure to any upward swing in the market – is much larger. Note that in a rising market, the magnitude of appreciation in the value of land is significantly larger than completed flats or flats under development. As such, by actively recycling proceeds raised from the market to raise funds to buy land, a developer can end up having similar (or even lower) level of debt, and yet have a much larger landbank size and being much more geared to the upturn in the market. In our view, this is probably the most important factor explaining CKP's performance during 2H03-2015.

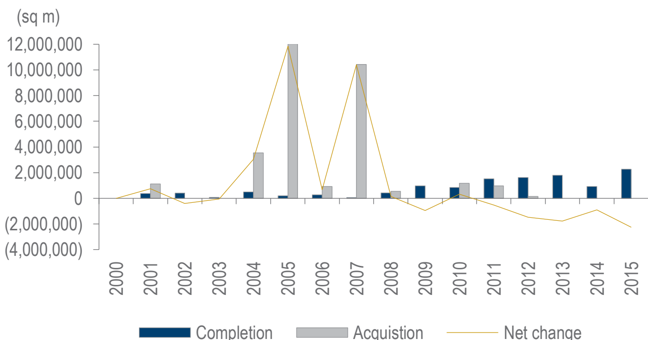
Compared with most other developers, CKP tends to focus more on the mass market where cost control, scale economies, efficient execution are a lot more important. We believe this orientation has both pros and cons. For developers that focus more on margins and the higher-end segment, profit per square foot can be a lot higher, but the volume can be constrained, the time it takes to realise such profit can be much longer, and the companies can be subject to risks related to a changing market environment.

Poised to harvest returns from its timely and decisive land purchases in Hong Kong and China

By way of contrast, developers focusing more on the mass market can manage much larger volume and recycle capital much faster. The market risk they face is also likely to be smaller given that their products appeal to a much wider group of customers. However, these developers must be able to control costs well and manage scale. They also need to be able to continuously identify value-enhancing opportunities to deploy capital.

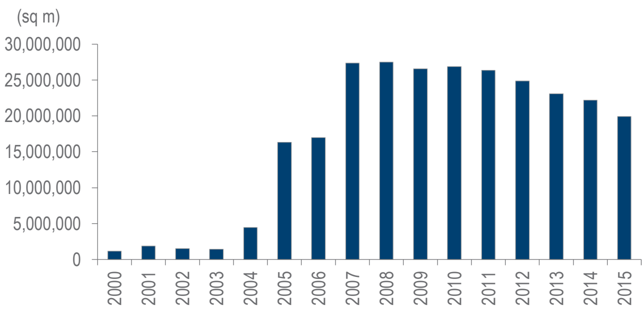
That said, our read is that the whole set-up of CKP's system is more geared to the mass market, and for shareholders, we believe such a focus would be applauded by some given that it entails quicker pay-back and probably lower capital requirements as well. In all, our read is that CKP's Hong Kong business has been an impressive machine for generating financial returns for shareholders and the group's decisive action to scale up its Hong Kong residential landbank early has helped underpin its position in the Hong Kong residential property sector.

CKP/Cheung Kong: annual land purchases, completion of property development businesses in China



Source: Company, Daiwa estimates

CKP/Cheung Kong: change in residential landbank in China



Source: Company, Daiwa estimates

A similar thing can be said about CKP's landbanking in China. In retrospect, CKP was among the earliest in terms of scaling up its China landbank. As the above table shows, CKP embarked on a major scaling up of its China landbank in around 2004 when the market generally was very sceptical about China property. In hindsight, CKP's current China landbank was mostly built up before 2007 and the group's timely and early landbanking in China has ensured that it has built up a sizeable China landbank at relatively low cost (average cost of land of about CNY2,300/sq m, we estimate) and in locations that are reasonably close to city centres.

In all, we believe CKP has an impressive record of generating financial returns for shareholders and secured an early and timely entry into the Hong Kong China land markets, from which it is now poised to profit.

2. Substantial monetisation in the years ahead

Time to harvest and monetise

The HKD153bn on the book at end-2015 stands to be monetised over the next few years

In our opinion, if 2004-06 was a period of major land purchases for CKP, then 2015 onwards should be a period of major monetisation of property assets for the group. At the end of 2015, CKP's total properties under development stood at HKD153bn (HKD65bn for Hong Kong and HKD88bn for China) and we expect a large part of it to be converted into cash over the next 3-5 years. We note that the set-up of CKP is like a machine for selling flats efficiently, and its track record indicates that it is capable of selling units quickly and efficiently even when overall market demand is not particularly strong.

CKP: achieved contract sales

	2012 (HKDbn)	2013 (HKDbn)	2014 (HKDbn)	2015 (HKDbn)	2016E (HKDbn)	2017E (HKDbn)	2018E (HKDbn)
HK	26.0	4.7	23.0	30.0	20.0	21.0	22.0
China	24.0	33.0	16.0	25.0	33.6	37.8	41.0
UK	0.0	0.0	0.0	0.7	0.8	1.2	1.6
Singapore	0.0	0.0	0.0	0.3	0.0	0.0	0.5
Total	**50.0**	**37.7**	**39.0**	**56.0**	**54.4**	**60.0**	**65.1**

Source: Company, Daiwa forecasts

In 2015, the total contract sales achieved by CKP was HKD56bn, and we believe the company has the sellable resources to sustain a similar level of contract sales over 2016-18 – we estimate it can achieve contract sales of over HKD160bn in 2016-18, driven by a gradual selling of its remaining Hong Kong landbank and a steady acceleration in the roll-out of its China projects.

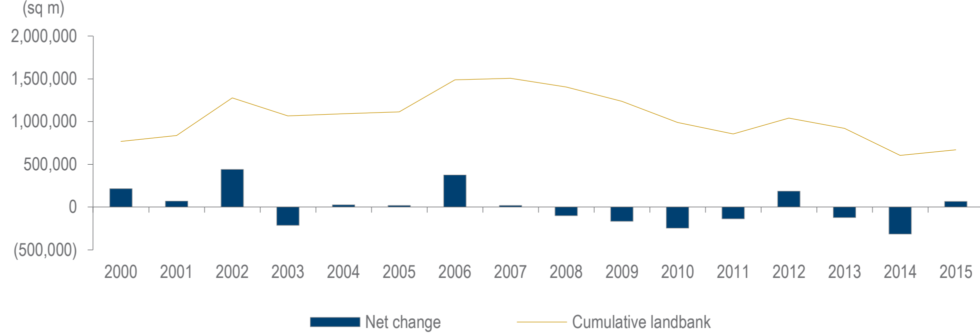
Does this mean the Cheung Kong group is bearish on Hong Kong and China and is trying to exit these 2 markets as soon as possible? We do not think we can make a conclusive judgement on this supposition. While CKP has been a net seller of property assets in both Hong Kong and China in recent years, it has been a significant net-buyer in both markets before, especially from 2004-06.

Has built up a lot in the past; is now the time to monetise?

In our opinion, the Cheung Kong group is an investor at heart. When the entry cost is low and expected upside is large, it can take a very large position and continue to add onto its position, as most value investors would do in such circumstances. However, when the cycle has progressed to a certain point, with entry cost becoming higher and expected upside becoming smaller than before, the Cheung Kong group would often become much more cautious and selective, as would most value investors.

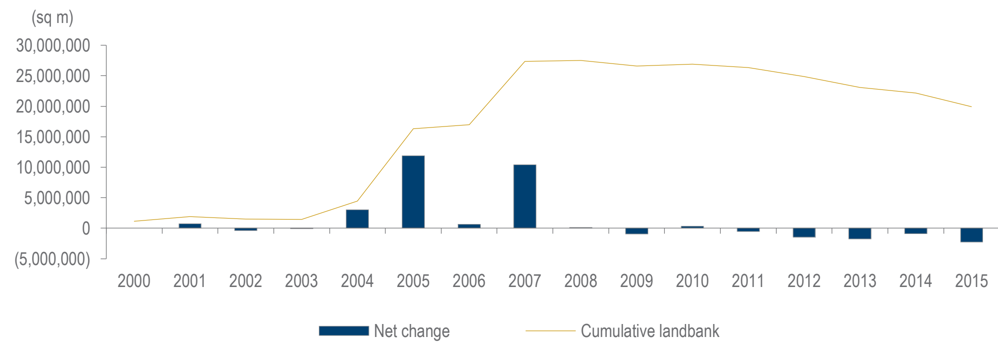
In this light, we do not think we can say conclusively that CKP is very bearish on Hong Kong and China property. After all, 7m sq ft of residential landbank in Hong Kong would merely bring its Hong Kong residential landbank position back to about the 1999 level – it significantly ramped up its Hong Kong landbank during 2001-06 (especially from 2004-06) but since then the net size of its residential landbank (after netting of completion and purchases) has been on the decline. That said, 7m sq ft of residential landbank in Hong Kong as of now (excluding 10m sq ft of agricultural land it is working on converting and other sites pending developments) would still make CKP the second-largest residential developer in Hong Kong in terms of GFA. As regards China, there has been a huge ramp-up in its China landbank since 2004 and its overall China landbank actually has started to decline since 2011 after it gradually ramped up its execution capability for large-scale property projects in the mainland.

CKP/Cheung Kong: net change in the size of its Hong Kong landbank



Source: Company, Daiwa estimates

CKP/Cheung Kong: net change in the size of its China landbank



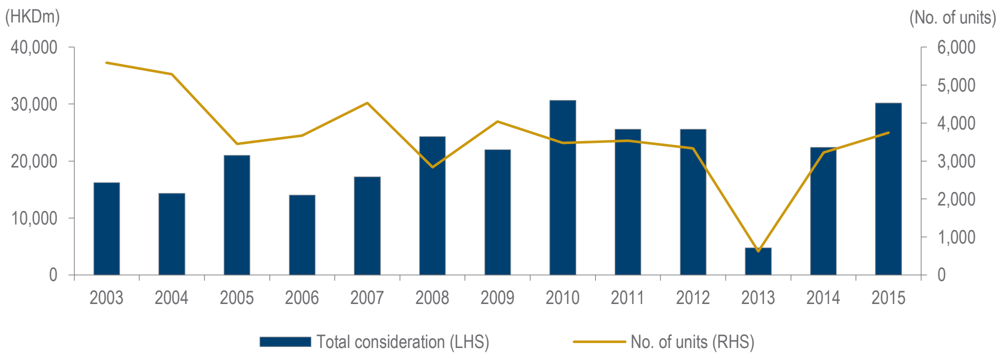
Source: Company, Daiwa estimates

In a way, what it has done might not be very different from what a price-and-capital-allocation-conscious value investor would do when it comes to stock investing: when the stock price is low and expected upside is large, such an investor would enlarge their position. Conversely, when the stock price has risen and expected upside has diminished, the investor may choose to trim their position and put the capital elsewhere, even if they remain long-term positive on the company's fundamentals.

The normal range for CKP's annual contract sales in Hong Kong is HKD22-31bn

In any case, CKP's track record suggests that it achieved contract sales in the range of HKD22-31bn in the Hong Kong residential property sector during 2010-15 (with the only exception being 2013 when the company achieved contract sales of only about HKD4.8bn as it was restrained from new launches during the year, probably to wait and see how the market responds to the stringent administrative measures announced in February 2013). Its average achieved contract sales in Hong Kong during this period was HKD23.2bn (after including the exceptional year of 2013) which would rise to HKD27bn if 2013 were excluded.

CKP/Cheung Kong: residential contract sales in Hong Kong



Source: Centaline, Daiwa

Shown below are the major projects CKP is likely to offer to the market from now until 2018. They cover a wide range of projects in different locations, some of which are rather unusual (such as the ones in Borrett Road and Oil Street). The largest among them are the projects above the West Rail Tsuen Wan Station and Lohas Park Package 8 which we see as established residential property locations with anchored end-user demand from people living in the older and smaller estates nearby. As such, we are comfortable about CKP being able to achieve our contract sales targets of an annual average of HKD20-24bn over 2016-18.

CKP: major Hong Kong residential projects for sale (2016-18)

Projects	Location	Stake	Attributable GFA (sq ft)	Est'd sales proceeds (HKDm)
Stars by Harbour (remaining units)	Hunghom	100%	109,724	1,931
The Zumurud	Homantin	80%	315,426	5,047
The Beaumount II	Tseung Kwan O	100%	549,168	5,711
La Mansion	Yuen Long	100%	65,401	576
RBL 177, Repulse Bay	Island South	100%	71,209	1,709
Borrett Road	Mid-level	100%	435,458	13,935
STTL 574, Ma On Shan	Ma On Shan	100%	562,380	5,849
West Rail Tsuen Wan Station	Tsuen Wan	JV	1,122,446	11,673
West Rail Tsuen Wan Station	Tsuen Wan	JV	1,113,530	11,581
Oil Street	North Point	100%	755,914	14,514
A site at Peel Street, Central	Central	JV	191,563	3,372
Lohas Park Package 8	Tseung Kwan O	JV	1,044,496	10,863
A site at Pei Ho Street	Shamshuipo	JV	595,923	4,767

Source: Company, Daiwa forecasts

Has been building up its execution capability in China

As for China, our read is that CKP has been ramping up its execution capability in the mainland, with achieved contract sales (combining with Hutchison Whampoa) exceeding the HKD20bn mark back in 2012. However, at that time, its contract sales were dominated by large-scale projects in Shanghai/Beijing which had high ASPs. As such, we see it as a sign of progress that CKP achieved contract sales of HKD25bn in 2015, and that was spread over more than 15 cities in the mainland.

As we see it, the most challenging task facing Hong Kong developers in China is the building up of the system (ie, the internal rules, guidelines and norms governing the execution of the real estate process from finding the sites, to coming up with the design, to determining on product and unit mix, overall project positioning, to sales & marketing, after sale service and management) and a human resources team, which can drive sustained growth in completion volume and contract sales, without compromising risk control and management. Our read is that CKP is one of the few companies serious about building up a sizeable China presence, and that its platform for driving sustained growth in its business scale in China has finally started falling into place in the recent years.

Its platform for executing mainland projects in multi-cities appears to be falling into place

Regarding CKP's China projects, we believe its recognised and contract sales have tended to be dominated by projects in Shanghai/Beijing and a few major cities such as Le Parc in Chengdu. However, in recent years, CKP's sales in various other cities, such as Nanjing, Wuhan, Chongqing, Dongguan, have also started picking up and we expect the next few years will be a time when CKP pushes up its China completions and contract sales volume, aided by the latest government policies. The government regards property as a major sector underpinning China's economy, which it is working towards transitioning from a fixed investment-led economy to one driven more by private consumption and the service sector.

Regarding CKP's China projects, we believe we have made a more thorough and in-depth study than peers and would highlight the 3 following points:

Sizeable exposure to China's tier-1 cities

First, in terms of distribution, CKP still has sizeable exposure to tier-1 cities like Shanghai, Beijing, Guangzhou, and Shenzhen especially if we count projects in the vicinity of these cities. In Shanghai, Beijing and Guangzhou, CKP has a landbank size of at least 0.8m sq

m in each city, which we consider sizeable. We estimate that some 3.8m sq m (19%) of CKP's current landbank is in the established city area of these 4 tier-1 cities, with the ratio rising to 6.6m sq m (34%) if we include projects in the vicinity of these cities as well.

CKP: China landbank

Source: Company

Note: The sq m figures for the cities above refer to total development property GFA for each city as at 28 February 2015. Please see note 3 for more details

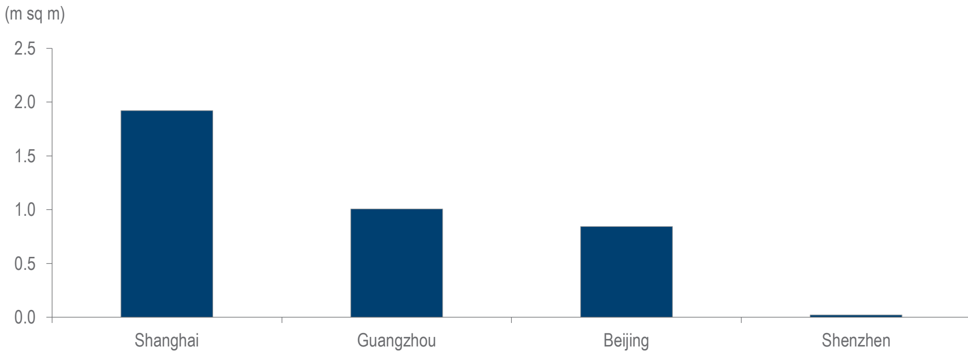
1. Comprises completed properties for sale only, not development land bank

2. Comprises cities with (i) completed properties for sale; (ii) completed properties for investment; (iii) completed properties for operation; (iv) properties under development and / or (v) properties for future development

3. Aggregate total GFA of approx. 19.7m sq m as at 28 February 2015 comprises development land bank, completed properties for sale and other areas (such as car park spaces) in the PRC. As at 31 December 2014, there was approx.14.5m sq m of development land bank located in China

Over 90% of its landbank value comes from tier 1 cities as well as 6 major tier-2 cities

CKP: landbank in tier-1 cities in China



Source: Company

Based on a valuation report by DTZ Debenham in February 2015, in terms of value, some 37% of DTZ Debenham's appraised value of CNY106bn for CKP's China development landbank is from tier-1 cities, which rises to 50% if the vicinity of the tier-1 cities is included. Note that outside the tier-1 cities, CKP's China landbank is concentrated in 6 major tier-2 cities – Chongqing, Chengdu, Wuhan, Dalian, Qingdao and Nanjing. Altogether, the 4 tier-1 cities and vicinities plus the above 6 major tier-2 cities account for over 90% of CKP's development landbank in terms of value.

In all, we consider CKP's China landbank to be a high quality one, offering significant exposure to the tier-1 and upper tier-2 cities in China, where land prices have generally been rising fast in the past 6-12 months; and CKP bought much of this land more than 5 years ago.

CKP: distribution of China landbank

	GFA (sq m)	(% share)	Value (CNYm)	(% share)
Four tier 1 cities				
Beijing	843,927	*4.3%*	7,229	*6.8%*
Shanghai	1,916,765	*9.7%*	23,703	*22.4%*
Guangzhou	1,007,819	*5.1%*	7,197	*6.8%*
Shenzhen	21,906	*0.1%*	729	*0.7%*
	3,790,417	***19.2%***	**38,857**	***36.7%***
Vicinity of the 4 tier 1 cities				
Tianjin	149,759	*0.8%*	3,314	*3.1%*
Foshan	261,997	*1.3%*	1,640	*1.5%*
Jiangmen	386,487	*2.0%*	423	*0.4%*
Zhongshan	65,559	*0.3%*	524	*0.5%*
Zhuhai	279,112	*1.4%*	711	*0.7%*
Dongguan	1,475,277	*7.5%*	7,387	*7.0%*
Huizhou	240,156	*1.2%*	129	*0.1%*
	2,858,347	***14.5%***	**14,128**	***13.3%***
Major tier 2 cities				
Wuhan	2,645,775	*13.4%*	12,789	*12.1%*
Chengdu	1,955,926	*9.9%*	8,929	*8.4%*
Chongqing	4,401,557	*22.3%*	7,274	*6.9%*
Qingdao	706,705	*3.6%*	5,983	*5.7%*
Nanjing	527,344	*2.7%*	5,882	*5.6%*
Dalian	1,261,138	*6.4%*	3,671	*3.5%*
	11,498,445	***58.4%***	**44,528**	***42.0%***
Other tier 2 cities				
Xian	511,064	*2.6%*	2,542	*2.4%*
Changsha	381,606	*1.9%*	1,265	*1.2%*
Changchun	534,743	*2.7%*	3,082	*2.9%*
Changzhou	121,050	*0.6%*	1,493	*1.4%*
	1,548,463	***7.9%***	**8,382**	***7.9%***
Total	**19,695,672**	***100.0%***	**105,895**	***100%***

Source: Company, Daiwa

Large sites in locations moving from fringe in the past to upcoming ones now

Second, many of CKP's projects are large in scale and located in areas that are up-and-coming. Our read is that when CKP started to scale up its China landbank in the early 2000s, its focus was not so much on the core areas. Instead, it seems to have preferred very large sites in locations that were not yet city centres, but were not far off becoming so *at that time.* We would emphasise the words "at that time" because we believe one strategy of CKP's is to buy large sites that have the potential to evolve into more like city-area projects over time, given the continued expansion of Chinese cities and the migration of the middle class away from city centre areas.

In our opinion, CKP has many sites that fall into this category. Take the Shanghai Upper West site as an example. It is located in the Puoto district which was a remote area in the 2000s and a new area when CKP acquired the site back in the mid-2000s. However, with the continued expansion of Shanghai city and the improvement in roads and public transport infrastructure, nowadays Puoto has become a well-established middle class area with prevailing ASP having gone up considerably from just about CNY10,000/sq m in the late 2000s to over CNY30,000/sq m now. As this project still has over 1m sq m of unbooked GFA (CKP's attributable stake is 60%) and that the Puoto district should continue to improve and mature as a location, we see considerable room for the achieved ASP for this project to rise over time.

CKP: Upper West project in Shanghai

Source: Sohu, Daiwa

Le Parc in Chengdu and Regency Hills in Chongqing is illustrative of CKP's strategy in China

Similarly, Le Parc in Chengdu is another case in point. It is a huge site of 4.3m sq m GFA located in a new district in Chengdu city. When CKP bought the site back in 2005, the whole area was almost entirely barren, and the site was the largest ever sold in Chengdu city. However, after over 10 years, the whole area has become more mature and is now a mid to high-end location in Chengdu city, as such the achieved ASP for this project has risen from about CNY5,000/sq m when it was first launched to over CNY9,000/sq m now. As there is still some 2.7m sq m developable GFA in this Chengdu project, the room for uplift in its achieved contract sales and profitability is substantial, even with just a modest rise in ASP.

CKP: Le Parc project in Chengdu

Source: Rider Levett Bucknall, WCWP Int'l Ltd, Daiwa

Regency Hill in Chongqing is another mega-site that offers significant leverage to the continued improvement of its location

Meanwhile, the group's Regency Hill project in Chongqing falls into the same category. It is a huge project with 4.1m sq m GFA and could arguably constitute a district in its own right. When we visited the project recently, we were impressed by its scale and the range of products that appear possible for this very large site. If executed well, it could resemble Telford Garden in Kowloon Bay or even have some elements of Kowloon Tong in the high-end component of this project. Location-wise, it is within 30 minutes from the city centre and we see considerable potential for this project if it can be executed well.

CKP: Regency Hills project in Chongqing

Source: Company, Phoenix New Media, Daiwa

Likewise, while CKP doesn't have a lot of projects in Nanjing, Wuhan and Qingdao, Dalian and Xi'an, those that it does have are sizeable projects in their own right, with Emerald City in Nanjing at over 0.5m sq m GFA while the Millennium Waterfront in Wuhan is over 0.4m sq m in GFA. For the group's Harbourfront in Qingdao, it is also over 1m sq m in GFA. More importantly, these projects have started selling and they already contributed to contract sales in 2015. Overall, we see these as important projects for the group in the next few years.

CKP: location of its major projects in Beijing

1 La Grande Ville
2 The Greenwich
3 Beixinjiayuan

Xicheng, Dongcheng, Yanqing, Huairou, Miyun, Pinggu, Changping, Shunyi, Haidian, Mentougou, Chaoyang, Shijingshan, Fengtai, Tongzhou, Fangshan, Daxing

Source: Daiwa

CKP: location of its major projects in Shanghai

1 Riviera Palace
2 Royal Waterfront
3 Upper West
4 Hupan Mingdi
5 Regency Garden
6 Century Link
7 City Link

Chongming, Baoshan, Jiading, Qingpu, Pudong New Area, Minhang, Songjiang, Fengxian, Jinshan, Zhabei, Yangpu, Putuo, Hongkou, Jingan, Changning, Huangpu, Xuhui

Source: Daiwa

CKP: location of its major projects in Guangzhou

1 Yuhu Mingdi
2 Cape Coral
3 Noble Hills
4 Guangzhou Guoji Wanjucheng
5 Maofengshan project

Conghua, Huadu, Zengcheng, Baiyun, Luogang, Tianhe, Yuexiu, Liwan, Haizhu, Huangpu, Menggang, Panyu, Nansha

Source: Daiwa

CKP: location of its major projects in Nanjing

1 Emerald City

Liuhe, Xixia, Pukou, Gulou, Xuanwu, Jianye, Qinhuai, Yuhuatai, Jiangning, Lishui, Gaochun

Source: Daiwa

En-bloc sale opportunities for major commercial properties

These large-scale projects bring us to the third feature of CKP's China projects. When CKP first bought into them, these projects were in unproven locations, and hence the commercial GFA portion of these projects commanded little market value. While these locations are unlikely to replace the existing CBDs, they could become more like satellite CBDs or niche areas for commercial property developments. Given that CKP often owns the most prime and largest sites in these new locations, we see room for it to monetise the value of these assets through block sales. Historically, CKP has raised considerable sales proceeds from en-bloc sales of large-scale commercial developments and we would not be surprised if it completes some similar deals in the next 6-36 months.

CKP: proceeds raised from commercial properties in China

Year	Properties	Cities	Stake	GFA (sq ft)	Achieved price (CNY/HKD)	Achieved price (HKD/sq ft)
2007	The Center	Shanghai	26%	963,336	CNY4.4bn	4,922
2008	Seasons Villas	Shanghai	50%	1,150,830	CNY4bn	3,948
2010	Oriental Plaza	Beijing	51%	6,162,881	HKD13.1bn	4,168
2012	Shenyang Lido Hotel	Shenyang	70%	nd	CNY980m	na
2012	Oriental Finance Centre	Shanghai	100%	2,368,058	HKD9,360	3,953
2013	Metropolitan Plaza	Guangzhou	50%	956,997	HKD3.05bn	3,187
2014	Metropolitan Plaza	Chongqing	50%	1,511,515	HKD4,976	3,292

Source: Company

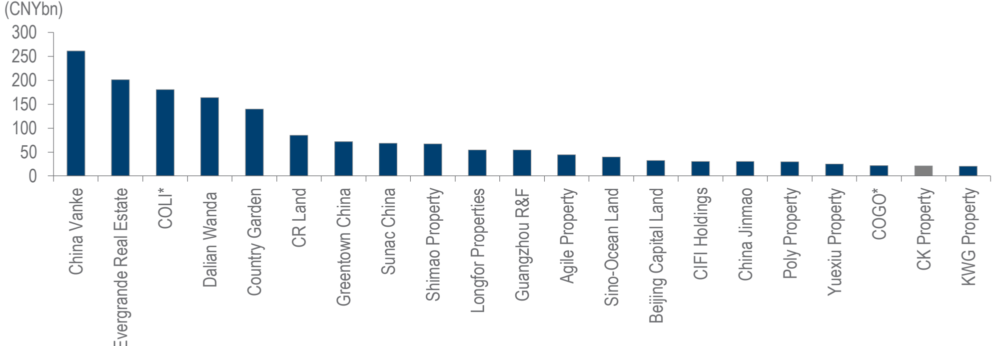
In our view, CKP is well-positioned to benefit from a major harvesting phase for its early investment in China property. At end-2015, China properties account for HKD88bn of CKP's book value, and DTZ Debenham estimates that the market value is HKD131bn based on a valuation as at February 2015. We think DTZ's valuation is realistic although we have come up with a more conservative figure of HKD106bn, which reflects Daiwa's house view on the USD/CNY exchange rate at 7.5 by end-2016 and also the reduction in its China landbank during February 2015 to end 2016. Indeed, we see room for the cash being realised in CKP's China projects to exceed our estimates or even those of DTZ. Given that the group has already started launching its various large key projects in several major cities (such as Nanjing, Wuhan, Qingdao, Chongqing, etc.) we see HKD112bn in contract sales revenue from China over 2016-18 as realistic and achievable.

We estimate that, over the next few years, the following projects will be key for CKP's property sales revenue and profit from China. The main contributing projects will be Le Grande in Beijing, Upper West in Shanghai, Cape Coral in Guangzhou, Le Parc in Chengdu, Emerald City in Nanjing, Millennium Waterfront in Wuhan, Regency Hills in Chongqing, The Harbourfront in Qingdao, and The Greenwich in Xi'an. Given that many of them have already launched phase one or more, and that the overall areas where these projects are located are only going to become more mature over the next 6-36 months, we believe their ability to sustain contract sales is strong. As such, we are comfortable with our contract sales forecast of HKD112bn over 2016-18, which would translate into about HKD37bn a year.

Note also that while HKD37bn in annual contract sales looks sizeable by Hong Kong standards, it is in fact quite modest relative to the achieved contract sales of the major players in China. In this light, we see room for positive revisions to CKP's contract and recognised sales in China. Note also that China Overseas Land & Investment (COLI) (688 HK, HKD22.40, Buy [1]) shows that China property can be a very scalable business, and when a company has mastered the way to manage large-scale residential projects in multi-cities in China, the room for revenue and profit expansion can be substantial.

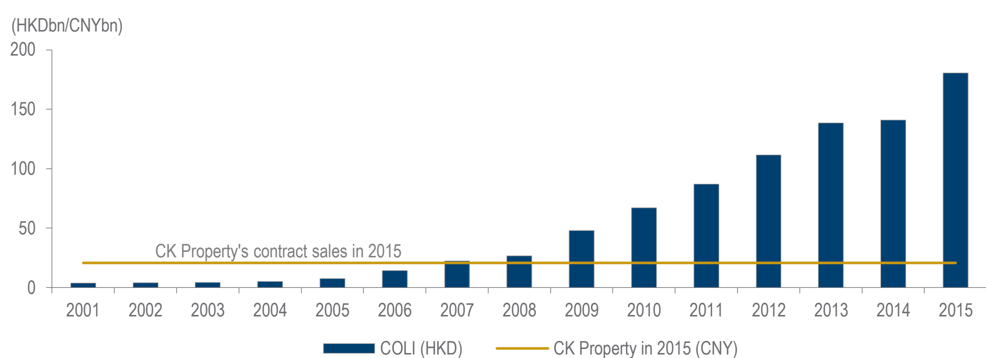
CKP's current contract sales level is similar to COLI's level back in 2007

Developers' contract sales in 2015 vs CKP



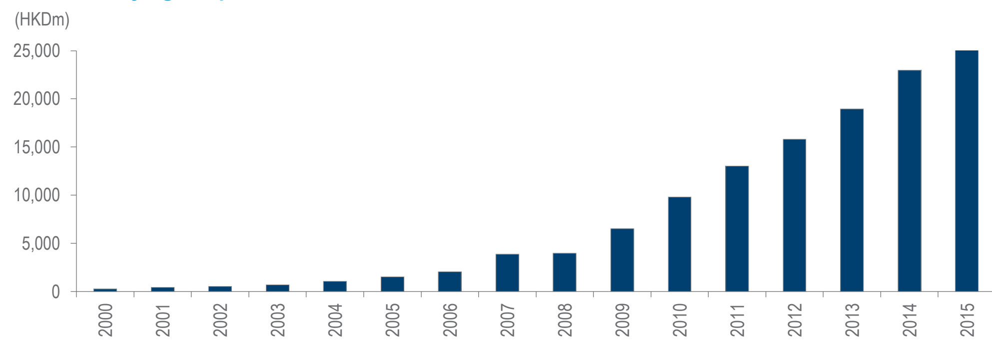
Source: Companies, Daiwa
*Note: *in HKD*

COLI: achieved contract sales



Source: Companies, Daiwa

COLI: underlying net profit record



Source: Company

3. Extra upside from Hutchison property and more

Additional oil could be added to this impressive machine

We have established that CKP has been an impressive machine for generating financial returns to shareholders in the past and that the group is poised to see significant monetisation of its Hong Kong and China landbank over 2016-18, amounting to HKD160bn or more on our estimates. The sale and booking of the company's sizeable Hong Kong China landbank should help protect its earnings and dividends over 2016-18, yet we see further upside stemming from the following areas.

Astute deployment of surplus capital

Track record of being innovative and entrepreneurial

First is its potential astute deployment of capital. As mentioned earlier, CKP is one of the few property companies in Hong Kong, or possibly even in Asia, that has a strong capital allocation mindset. It has been innovative and entrepreneurial in terms of deploying capital in new areas, and this has allowed it to build up a hotel and serviced suites business in Hong Kong, be a pioneer in sponsoring the development of REITs in Hong Kong, and made it among the pioneers in Hong Kong to build up a business presence in Singapore and London.

With over HKD160bn in cash from property sales estimated to flow in over 2016-18E, CKP's ability to invest in new areas will be strong. If it can find new areas that can provide attractive returns, the impact of this HKD160bn could be substantial.

Could even engage in M&A opportunities in global property

We see HKD160bn as a sizeable amount of cash, even by global property standards. As such, we would not be surprised if CKP starts to show an interest in M&A deals in global property. The Cheung Kong group's track record suggests that the group has confidence in the regulatory regime of Commonwealth countries because a lot of past investments were in businesses located in Commonwealth countries. As such, we would not be surprised if CKP started to seek attractive M&A opportunities arising in the REIT or property sectors in countries like Canada, Australia or the UK. If there are global property companies or REITs that can provide a reliable rental yield of say over 6%, it would probably make financial sense for CKP to consider buying, if only to secure a higher return for the abundant cash it is poised to receive over the next few years.

Raising stakes in H-REITs would make financial sense

Meanwhile, we note that several REITs under CKP already offer a sustainable DPU yield of over 6%. In theory, just continuing to raise its stakes in these companies would already provide yield enhancement for CKP's surplus cash.

CKP: stakes in various H-REITs and in ARA Asset Management

	Stake (%)	Share price (local ccy)	Issued shares (m)	Exchange rate	Valuation (HKDm)
Hui Xian REIT	32.3	3.10	5,326	1.18	6,293
Fortune REIT	28.0	8.56	1,879	1.00	4,505
Prosperity REIT	19.3	2.98	1,428	1.00	821
ARA Asset Management	7.8	1.34	845	5.63	495
					12,114

Source: Company, Bloomberg, Daiwa

Unlocking the value of Hutchison Property and bringing out the full potential of a much enlarged property group

Another area that could provide a positive surprise to investors is progress in realising the value of Hutchison Property, with which it was merged, pursuant to the CK Group reorganisation in early 2015. In our opinion, it is important not to underestimate the significance of the Cheung Kong group reorganisation to CKP's fundamentals as a property company. In our opinion, the Cheung Kong group reorganisation was akin to CKP merging with another property company of a similar size, and we believe the reorganisation will have 4 major impacts on CKP as a property company, which we analyse below.

Impact of combining CKP and Hutchison Property

		Cheung Kong Property Group*	Hutchison Property Group*	Cheung Kong Property*
Investment properties	Rental properties in HK, China & overseas	~4m sq ft	~13m sq ft	~17m sq ft
Development properties	Development landbank in HK	~8m sq ft	-	~8m sq ft
	Development landbank in China	~80m sq ft	~77m sq ft	~158m sq ft
	Development landbank overseas)	~3m sq ft	~2m sq ft	~5m sq ft
	Total	~91m sq ft	~79m sq ft	~170m sq ft
Hotel and serviced suites	No. of hotel rooms in HK	8,710	3,440	12,150
	No. of hotel rooms outside HK	650	1,880	2,530
	Total	9,360	5,320	14,680
Property management	Properties under management in HK China			21m sq m
REITs and asset managers	Stake in Fortune REIT			28.0%
	Stake in Prosperity REIT			19.3%
	Stake in Hui Xi'an REIT			46.2%
	ARA Asset Management			7.8%
	Hui Xi'an Asset Management			30.0%

Source: Company
*Note: *Figures are based on corporate presentations in Jan-May 2015 and are not updated with the most current figures*

Hutchison's large rental portfolio complements CKP's model

1) Offering a rental income stream to complement CKP's property sales business
One point to note about the property portfolio of Hutchison is that it complements CKP's very well in terms of asset mix and earnings structure. For all the merits associated with CKP's asset turnover/land trading model, one trade-off of such a business model is that it does not allow the company to tie up substantial capital to nurture and manage commercial properties, which is required if a company is to excel in the business of commercial property. CKP appears to have tried to address this issue by investing in serviced apartments, which arguably resemble rental properties and provide a recurrent income stream. That said, we believe serviced apartments cannot match office/retail properties in certain aspects, and it appears that as a property company, CKP may have to miss something if it does not have a sizeable investment property portfolio. In this light, merging with Hutchison Property was probably a good move for CKP, as Hutchison Property has a sizeable rental property portfolio. As such, merging with it has given CKP immediate access to a large rental portfolio which otherwise could have required 2 decades and probably over HK80bn to build.

We see still considerable value to be extracted from property assets previously owned by Hutchison

2) Offering rental properties with the potential for an improvement in achieved rents
Moreover, we believe there is considerable room for improvement in the achieved rents of Hutchison's rental properties which are now owned by CKP. Shown below are the achieved passing rents for several major investment properties previously owned by Hutchison Property and now under CKP and we see considerable room for improvements in terms of their positioning and achieved rents. Our read is that managing commercial properties was not Hutchison's key focus in the past and this suggests there could be considerably more value that can be extracted from it if the assets are to be managed by savvy and experienced managers of real estate assets.

Achieved rents for various major investment properties previously owned by Hutchison

				Passing rent (gross)			
Property	Usage	Location	GFA (sq ft)	2014 Per sq ft (HKD)	2015 Per sq ft (HKD	2014 Total (HKDm)	2015 Total (HKDm)
Central							
Cheung Kong Center	Office	Central	1,263,371	100	106	1,513	1,608
The Center	Office	Central	1,218,162	57	61	837	889
Hutchison House	Office	Central	503,723	60	62	364	373
China Building	Office	Central	258,756	90	95	280	296
			3,244,012			**2,994**	**3,166**
Outside Central							
Tower 1, The Harbourfront	Office	Hunghom	431,152	21	22	108	112
Tower 2, The Harbourfront	Office	Hunghom	431,841	21	22	108	112
			862,993			**216**	**224**

Source: Company, Daiwa

Central offices owned by CKP

Property	GFA (sq ft)	Passing rent (gross) 2014 Per sq ft (HKD)	2015 Per sq ft (HKD	2014 Total (HKDm)	2015 Total (HKDm)
Cheung Kong Center	1,263,371	100	106	1,513	1,608
The Center	1,218,162	57	61	837	889
Hutchison House	503,723	60	62	364	373
China Building	258,756	90	95	280	296
	3,244,012			**2,994**	**3,166**

Source: Company

The second-largest office landlord in Central

3) Lifting CKP's position as a major office landlord in Central

We think one aspect that may have escaped the attention of many is that CKP is actually the second-largest office landlord in Central (3.24m sq ft GFA) after Hongkong Land (HKL SP, USD6.08, Buy [1]) (about 4.9m sq ft of office space based on GFA). However, it has not managed its various properties like an integrated portfolio and we see room for an improvement in the positioning and rental potential for CKP's properties such as Hutchison House, China Building and The Center. One case in point is the Murray Road carpark site which should be available to the market by 2H16. Given that this property is right next to Hutchison House, we believe it would be a good strategic fit with CKP's office portfolio in Central, and if CKP gets the site at reasonable price, it could be a major step forward in CKP becoming a major landlord in Central.

Many non-core assets that it can monetise

4) Monetising the value of non-core assets

We think one consequence of the injection of Hutchison Property's assets into the newly formed CKP is that CKP now has a lot more non-core assets. Given the falling domestic borrowing cost in China and many corporations' strategy to invest abroad, we see considerable opportunities for property owners in Hong Kong to realise the value of their non-core assets. Since November 2015, Hong Kong property companies have realised over HKD30bn through selling prime property assets to mainland entities. We expect such a trend to continue presenting CKP with some interesting opportunities for asset disposal in the next few years.

Take The Center as an example. This building is one of the few iconic buildings on the fringes of Central. If it is sold, we would not be surprised if the achieved price reached well over HKD25,000/sq ft – we currently value it at HKD18,667sq ft. That said, we reckon some Chinese entities are not price-conscious and demand to have ownership over assets they like. As such, we see this situation creating opportunities for property companies like CKP which owns a lot of non-core smaller assets in its portfolio from which it could raise a few billion from each if they were offered to the market. In addition, we think it is also noteworthy that CKP has a number of REITs that could buy some of these assets. All-in-all, we believe CKP has a lot of potential in terms of monetising the value of its non-core assets.

Non-core properties now under CKP

Property	Usage	Location	GFA (sq ft)
The Center	Office	Central	1,218,162
China Building	Office	Central	258,756
Tower 1, The Harbourfront	Office	Hunghom	431,152
Tower 2, The Harbourfront	Office	Hunghom	431,841
Hutchison Telecom Tower	Office	Tsing Yi	300,338
Wonderful Worlds of Whampoa	Retail	Hunghom	1,714,006
Aberdeen Centre	Retail	Aberdeen	345,026
Victoria Mall	Retail	Tsimshatsui	143,040
United Centre (various shops)	Retail	Admiralty	37,803
Rambler Crest	Retail	Tsing Yi	44,175
Hunghom Bay Centre	Retail	Hunghom	80,422
Chun Fai Centre	Retail	Tai Hang	32,373
Fine Mansion	Retail	Happy Valley	13,704
Conic Investment Building	Industrial	Hunghom	327,414
Cavendish Centre	Industrial	Aberdeen	342,923
Watson Centre Kwai Chung	Industrial	Kwai Chung	687,295
Watson Centre Fo Tan	Industrial	Shatin	280,923
Fanling Sheung Shui Town Lot 97	Industrial	Sheung Shui	142,416
Provident Villas	Residential	Pokfulam	19,343
23 Coombe Road	Residential	The Peak	6,124
Baguio Villa	Residential	Pokfulam	12,967
			6,870,203

Source: Company, Daiwa

Non-core assets disposed by Cheung Kong in the past

Year	Assets	Type	Method	Buyer	Stake	Proceeds
2011	HPH Trust (HPHT SP)	Ports	Spin-off	IPO	26%	USD5.5bn
2011	Hui Xian REIT (87001 HK)	Property	Spin-off	IPO	50%	CNY10.5bn
2012	Shenyang Lido Hotel	Hotel	Outright sale	Hui Xian REIT	100%	CNY980m
2013	Kingswood Ginza	Property	Outright sale	Fortune REIT	100%	HKD5.8bn
2013	Oriental Financial Centre, Shanghai	Property	Outright sale	China Everbright	100%	CNY7.1bn
2014	Metropolitan Plaza	Chongqing	Outright sale	Hui Xian REIT	100%	CNY3.91bn

Source: Hong Kong Economic Times, SCMP, Daiwa

5) Building on its hotel/serviced suite business

Three astute land purchases laid the foundations for CKP's serviced suite businesses

We see serviced suites as an interesting asset within CKP. Like most other new businesses under the Cheung Kong group, CKP's involvement in the serviced suites business (which we see as an extension/evolution of its hotel business) started with the company securing a low-cost entry into the sector, with the purchase of 3 sites at bargain prices. In retrospect, CKP's entry into this new business can be dated back to a land acquisition it made in March 2008, which allowed it to acquire the site for the current Horizon Suite Hotel in Ma On Shan for just HKD200/sq ft. This was then followed by 2 more acquisitions of hotel sites in Hunghom in 2011 for HKD543/sq ft and HKD943/sq ft, respectively. This then provided the company with a strong foundation to scale up this business; and we note that, by now, CKP is already the largest hotel and serviced suites operator in Hong Kong, owning and managing a total of 12,328 rooms.

At the end of 2015, these assets accounted for only HKD13bn on the book (translating into about HKD1m per room) as Hong Kong accounting treats such assets as operating assets which need to be depreciated over time. In reality, their value has risen a lot (we value it at HKD66.4bn, translating into a blended average valuation of HKD5.4m per room) and CKP is already the largest player in this segment. In our view, one area for CKP to explore is to build up on its current strong market position to continue to acquire more such assets. In the future, it could sell a part of the portfolio or list it through a REIT or other structure. In all, we see its serviced suite business as an interesting niche of assets where the value to be monetised could be substantial.

CKP: foundation of its portfolio of hotels and serviced suites Hong Kong

Date	Site	GFA (sq ft)	Price (HKDm)	Accommodation value (HKD/sq ft)
Mar 1998	STTL 461, Ma On Shan	614,520	120	196
Aug 2001	KIL No. 11110, Hung Hom Bay Reclamation area	1,156,483	1,090	943
Oct 2001	KIL No. 11103, Hung Hom Bay Reclamation area	1,283,546	655	510

Source: Company

CKP: portfolio of hotels and serviced suites in Hong Kong

	Location	Stake	GFA (sq ft)	No. of rooms	Year of opening
Serviced suites					
Harbourview Horizon	Hunghom	100%	1,283,930	1,662	2005
Harbourfront Horizon	Hunghom	100%	1,156,527	1,980	2006
Horizon Suite Hotel	Ma On Shan	100%	602,784	831	2002
The Apex Horizon	Kwai Chung	100%	228,089	360	2007
			3,271,330	**4,833**	
Hotels					
Harbour Grand Kowloon	Hunghom	100%	510,935	555	1995
Harbour Plaza Metropolis	Hunghom	100%	461,313	821	2002
Sheraton Hong Kong	Tsimshatsui	39%	666,830	782	1974
The Kowloon Hotel	Tsimshatsui	100%	329,486	736	1985
Harbour Grand Hong Kong	North Point	100%	444,995	828	2008
Harbour Plaza North Point	North Point	100%	343,081	669	1999
Harbour Plaza 8 Degrees	To Kwa Wan	100%	230,565	704	2009
Rambler Garden Hotel	Tsing Yi	100%	211,114	800	2003
Rambler Oasis Hotel	Tsing Yi	100%	213,235	822	2003
Harbour Plaza Resort City	Tin Shui Wai	98%	662,126	1,102	1999
			4,073,680	**7,819**	
Total			**7,345,010**	**12,652**	

Source: Company

Has established a meaningful presence in the UK and Singapore

6) Building up a presence in Singapore and the UK

We believe CKP used to be more entrepreneurial in terms of new initiatives. It first entered Singapore in 2000, and had more or less sold all of its projects in Singapore by the end of 2015. However, it was able to sustain its presence in Singapore through purchasing the Upper Serangoon site at the end of 2014. In the meantime, it has been building up a presence in the London property market and has now become one of the largest players in the Chelsea area of London, which has been an upmarket location in London for many decades. Meanwhile, it also owns a large piece of land in Convoys Wharf (in Deptford, southeast London) which provides another source of earnings upside. London started contributing to contract sales in 2015 and we see room for the UK to become a niche segment in CKP's property businesses.

CKP: landbank in London

Projects	Location	Stake	Total GFA (sq ft)	Attri. GFA (sq ft)	Year of completion
Chelsea Waterfront on Lots Road	Chelsea	95%	48,499	46,074	2016
		95%	106,334	101,017	2017
		95%	58,287	55,373	2017
		95%	89,374	84,906	2018
		95%	230,209	218,699	2018
		95%	270,664	257,131	2019
A site at Convoys Wharf	Convoys Wharf	100%	3,093,216	3,093,216	2020

Source: Company

4. More share buybacks on the cards

Could it once again be a pioneer, this time in the modernisation of capital management?

As mentioned already, CKP should have abundant cash returning to it over the next 3-36 months, and it remains to be seen how the company would deploy such surplus capital. Historically, the Cheung Kong group has been more innovative than many peers when it comes to deploying capital. We see a number of options for CKP. On the one hand, it could start investing in new areas, such as aircraft leasing and Cheung Kong Infrastructure as it did in the past. At the same time, it could buy more land, in Hong Kong, China, Singapore, the UK or even new markets. Meanwhile, it could pay a higher dividend (which it has been doing) and also buy back more shares (which it started doing in March 2016).

Will the Hong Kong family property companies accept share buybacks as a legitimate and attractive way to deploy capital?

There has been a cultural barrier among Hong Kong family companies in terms of seeing the merits of share buybacks

It appears to us that there is a wide cultural gap between the ways Hong Kong family-run companies see share buybacks and the perspective of global capital markets. While some may regard share buybacks as merely a form of financial engineering or even share-price manipulation, there are others in the investing world who see share buybacks as the first and basic step in responsible capital management.

In our view, there is a subtle but important difference between the controlling family using their own capital to raise their stake in a company, and the company using its own capital to buy back the shares and then cancel them. The former would not result in any change in the EPS, DPS or book value of the company; while on the contrary, the latter option, as long as the shares were bought back at a discount, could lead to an enhancement in the EPS, DPS and book value of the company, however small the enhancement may be.

In our opinion, the main significance of a share buyback scheme is not so much the size of the share repurchase or whether the exercise can result in any positive impact on the share price. Rather, we think its main importance lies in the establishment of a mechanism that allows companies to use their cash flow and balance sheet to protect their equity value when the company judges that it is desirable to do so. This, in turn protects minority shareholders' capital put into listed companies. In this sense, we think the main significance of a share buyback is that it can signal potential progress in the governance of a modern listed company.

Are providers of capital at the secondary market level also providers of capital to the company?

Traditionally, we think most corporate managers in Asia have seen their main responsibility as finding attractive investments to create value for shareholders, and most major shareholders in Asia want to see a company's capital being used to create something tangible. While we can see the reasoning behind this view, we also believe providers of equity capital at the secondary market level are also providers of capital to a company. To the extent that some of a company's capital is provided by investors, we think it is only fair and legitimate that the minority investors should have a say as to how the capital of a company is deployed. And to the extent that some investors like to see a company's capital being used to protect the company's equity value, this should already constitute a legitimate option for the company to consider when it comes to evaluating capital allocation for various areas/assets.

Moreover, financially, when a company's shares are trading at a significant discount to their NAV and when the company is committed to increasing dividends, there should be a point at which a company's financial position and strength would actually improve if it bought back shares and saved itself the cost of paying dividends in the years ahead. In this light, we view share buybacks as one legitimate way to deploy a company's capital, and believe the relative merits of share buybacks deserve to be evaluated relative to using capital to invest more or to pay out a cash dividend to shareholders.

Share buybacks don't necessarily shrink the size or liquidity of a company

Although it is a popular theory that share buybacks can shrink the size and liquidity of a company, we think reducing the number of shares may not necessarily reduce the free-flow and market capitalisation of a company. Another important part of the equation is how the shares are to be valued by the market. To the extent that share buybacks can enhance the value of minority investors' shares – and hence their value in the public market – then it is theoretically possible that a company's market capitalisation and free-flow could increase even if the number of shares decline.

Should investors focus on per share value or just asset size?

From the investors' perspective, what matters the most in our view is the per-share value of the business rather than the absolute size of the assets it owns. Herein could lie one of the potential differences in priorities between investors and controlling families. While some families may desire owning more assets for the benefits of posterity, investors would rather see a company deploy capital in the most effective way to enhance the "per share value" of the business. When the prospects of new investments are not attractive enough, investors are of the opinion that a company may be better off using the cash to buy back its own shares at a discount which would enhance the book value, EPS and DPS of the company, to the benefit of all shareholders.

In the ultimate analysis, we think the issue boils down to the question of what are the proper responsibilities of a publicly listed company. In the context of Hong Kong property companies, we think one tricky issue is that many players just do not have any need for equity capital as they are very lowly geared, while banks are lining up to supply credit at low borrowing costs. In hindsight, one might wonder whether some families would have been better off if their companies had not been listed years ago.

Integrating into the global capital markets: to be or not to be?

Having said that, however, we believe there are potential benefits associated with having a listing status, and the option of accessing the global capital markets when a company judges it to be desirable to do so. After all, many of the world's largest and most profitable companies are listed and some are active in making use of the opportunities provided by the global capital markets. Nevertheless, becoming listed also exposes a company to more scrutiny by the stock market and the investing community, and provides certain forces to ensure the company conducts its business in a way that is transparent and in line with the prevailing and evolving standard of corporate governance.

Whether having a listing status is net positive or not to the development of a company or the Hong Kong property companies is an issue that is beyond the scope of this report. But we would say that property is essentially a capital-intensive business, and if a company can have an equity valuation that allows it to get capital at favourable terms, the potential and possibilities open to the business could be larger than if they did not have this opportunity. In any case, many of the largest and most respected companies in the world have chosen to play by the rules of the global capital markets. We think one issue that many owners of Hong Kong family property companies need to evaluate is whether they want their companies to move towards joining the group of modern global corporations, or whether they prefer to become privatised if such an opportunity arises.

The Cheung Kong group has cast an important vote to accept the global capital markets and share buybacks

The Cheung Kong group reorganisation was a landmark event in the Hong Kong corporate sector

In this connection, we think the Cheung Kong group reorganisation announced on 9 January 2015 was a landmark event in the Hong Kong corporate sector in that we see it as the first attempt made by a major family business group in Hong Kong, or even Asia, to move closer to becoming a modern corporation and to play by the rules of the global capital markets (see our special report: *Cheung Kong/ Hutch's Bold Move,* published 9 February 2015).

In our February report, we argued that there is a good case for the Cheung Kong group to use its abundant surplus cash it is going to receive over the next few years to buy back its own stock if it continues to trade at a large discount to its underlying business value, and that the January 2015 reorganisation has made such a goal technically much more

feasible to implement (see Question 5 of our special report: *Cheung Kong/ Hutch's Bold Move*, on 9 February 2015). In this connection, we see it as an important sign that the Hong Kong Stock Exchange disclosed on 21 March 2106 that CKP had bought back some 13.5m of its own shares – the first time such action had been taken by one of the largest property companies in Hong Kong. This move was an important breakthrough in the capital management of family property companies in Hong Kong, in our view, and could have significant implications for how these companies are perceived and priced in the global capital markets (see *The first major share buyback*, published on 22 March 2016).

CKP: 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%
Total	**13,535,000**	**46.725**	**632.4**	**0.351%**

Source: HKEx

Not yet clear how far it will go ...

At this stage, it is unclear whether this share buyback by CKP was a one-off move driven by price, or whether it could be the beginning of a change in the way the company evaluates the various options it has in terms of deploying its capital. Still, we believe this development is important as it symbolises the first major breakthrough by a major Hong Kong family company in terms of the way it views share buybacks. And we see share buybacks as an important way to address the issue of the large NAV discount on Hong Kong property companies (see also section 6 of our Swire Properties initiation report: "*A large "nurturing reward" awaits*", published in May 2014).

… but we think the merits are clear and strong …

In any case, our view is that share buybacks represent one option CKP has to create value for Cheung Kong shareholders in the years to come and to deploy the abundant cash that it stands to return to the company over the next years. Based on the existing regulatory framework in Hong Kong, technically CKP can buy back up to a maximum of 6% of its stock without triggering an increase in the Li family stake, which is within the regulatory limit of 2% a year. This buyback would translate into a maximum of 240m shares for the first year. Assuming CKP bought back 200m shares a year over the next few years, this would require about HKD10bn per year based on a share price of HKD46.725 (the average price CKP paid in March 2016).

Given that CKP should have over HKD100bn in cash returning over the next few years, we think the company could well afford raising its DPS while at the same time undertaking continuous share buybacks if its stock valuation stays at current depressed levels. Shown below is a hypothetical case whereby CKP raises its annual dividend by HKD1bn a year (which we think it can well afford) and buy back 200m shares a year over the next 3 years (we assume a share price of HKD46.725 for simplicity's sake), which illustrates that just this exercise alone would bring notable benefits to CKP's book value and DPS. We estimate that if combined with a share buyback, CKP's annual DPS could rise to HKD3.99 and would give it an 8.8% dividend yield based on the prevailing share price (83% above the DPS level of HKD2.18/share had the group not undertaken any share buyback and just raise its annual dividend by HKD1bn a year).

CKP: impact of a share buyback on cash flow, NAV and DPS

Outstanding no. of shares (m)	NAV (HKDm)	Cash required# (HKDm)	Annual interest extra expenses or annual income lost* (HKDm)	NAV per share (HKD)	Li Family & Trust's stake	Dividends for 2015 (HKDm)	DPS (HKD)
3,860	390,864	-	-	101.3	30.20%	5,404	1.4
3,846	390,232	(632)	-	101.5	30.30%	5,404	1.4
3,840	389,911	(935)	(19)	101.5	30.30%	5,404	1.41
3,820	388,958	(1,869)	(37)	101.8	30.50%	5,404	1.41
3,800	388,004	(2,804)	(56)	102.1	30.60%	5,404	1.42
3,780	387,051	(3,738)	(75)	102.4	30.80%	5,404	1.43
3,760	386,098	(4,673)	(93)	102.7	31.00%	5,404	1.44
3,740	385,145	(5,607)	(112)	103	31.10%	5,404	1.44
3,720	384,192	(6,542)	(131)	103.3	31.30%	5,404	1.45
3,700	383,238	(7,476)	(150)	103.6	31.50%	5,404	1.46
3,680	382,285	(8,411)	(168)	103.9	31.60%	5,404	1.47
3,660	381,332	(9,345)	(187)	104.2	31.80%	5,404	1.48
3,640	380,379	(10,280)	(206)	104.5	32.00%	5,404	1.48
3,620	379,426	(11,214)	(224)	104.8	32.10%	5,404	1.49

Source: Daiwa
*Note: * we assume 2% pa*
 # assuming an average price of HKD46.725 which was the average price CKP has paid for the first batch of shares it has bought back in March 2016

CKP: impact of a combination of share buyback and dividend rise^

Outstanding no. of shares (m)	Amount of shares to be cancelled (m)	Annual dividends (HKDm)	DPS (HKD)	Dividend yield** (%)	Li Family & Trust's stake
3,860	-	5,404	1.40	2.8%	30.2%
3,846^^	(13.5)	5,904	1.54	3.1%	30.3%
3,840	(20.0)	6,404	1.67	3.3%	30.3%
3,820	(40.0)	6,904	1.81	3.6%	30.5%
3,800	(60.0)	7,404	1.95	3.9%	30.6%
3,780	(80.0)	7,904	2.09	4.2%	30.8%
3,760	(100.0)	8,404	2.24	4.5%	31.0%
3,740	(120.0)	8,904	2.38	4.8%	31.1%
3,720	(140.0)	9,404	2.53	5.1%	31.3%
3,700	(160.0)	9,904	2.68	5.4%	31.5%
3,680	(180.0)	10,404	2.83	5.7%	31.6%
3,660	(200.0)	10,904	2.98	6.0%	31.8%
3,640	(220.0)	11,404	3.13	6.3%	32.0%
3,620	(240.0)	11,904	3.29	6.6%	32.1%

Source: Daiwa
*Note: ** assuming HKD50/share for CKP for simplicity*
^ the table refers to the impact of every HKD500m rise in annual dividend and every repurchase of 20m shares
^^ the current number of O/S shares after the share repurchase in March 2016

CKP: cumulative impact of continuous share buybacks and dividend rise in 3 and 5 years

Date	Outstanding no. of shares (m)	NAV## (HKDm)	Cash required# (HKDm)	Annual interest extra expenses or annual income lost* (HKDm)	NAV per share (HKD)	Li Family & Trust's stake	Dividends for s/holders*** (HKDm)	DPS (HKD)	Dividend yield**(%)
Jun 2015	3,860	390,856	-	-	101.3	30.2%	5,404	1.40	2.8%
Apr 2016	3,846	390,232	(632)	-	101.5	30.3%	6,404	1.66	3.3%
Dec 2018	3,260	361,708	(28,035)	(1,346)	111.0	35.7%	8,404	2.58	5.2%
Dec 2020	2,860	340,215	(46,725)	(2,804)	119.0	40.7%	11,404	3.99	8.0%

Source: Daiwa
*Note: * we assume 2% pa*
*** assuming HKD50/share for CKP for simplicity*
**** assuming an annual increase of HKD1bn from the level of HKD5,404m (HKD1.40/share) in 2015*
 # assuming an average price of HKD46.725 which was the average price CKP has paid for the first batch of shares it has bought back in March 2016
we have assumed a static NAV for simplicity and illustration purposes

A safe, equitable and flexible way to benefit all shareholders?

Shown below is our estimate of CKP's cash flow profile in the next few years. We think it illustrates that CKP has considerable capability to raise its DPS and engage in share buybacks in the coming years. Based on our projection, CKP should move into a net cash position by the end of 2016. More importantly, it should remain net cash even if it raises its annual dividend paid to shareholders by HKD1bn and spends HKD10bn (200m shares @ HKD50/share) in share buybacks.

CKP: cash flow profile in 2016-2018

HKDbn	2016E	2017E	2018E
Property contract sales	54.4	60.0	65.1
Cash collected from property contract sales	43.5	48.0	52.1
Net rental income	7.5	7.8	8.2
Hotel and serviced suites EBITDA	1.5	1.8	2.0
Property management EBITDA	0.3	0.3	0.3
Distributable income from REITs	0.9	1.0	1.0
Dividends	(5.6)	(6.2)	(6.9)
Share buyback	(0.6)		
Construction cost, interest cost, working capital & others	(12.0)	(13.3)	(13.9)
Capex	(8.0)	(10.0)	(11.0)
Tax	(6.9)	(7.8)	(8.5)
Net cash inflow/ (outflow)	**20.7**	**21.7**	**23.3**
Net cash/ (Net debt) b/f	(15.1)	5.60	27.3
Net cash/ (Net debt) c/f	**5.60**	**27.3**	**50.6**

Source: Daiwa forecasts

CKP: cash flow profile in 2016-2018 (after adjusting for additional cash dividend and share buyback)

HKDbn	2016E	2017E	2018E
Property contract sales	54.4	60.0	65.1
Cash collected from property contract sales	43.5	48.0	52.1
Net rental income	7.5	7.8	8.2
Hotel and serviced suites EBITDA	1.5	1.8	2.0
Property management EBITDA	0.3	0.3	0.3
Distributable income from REITs	0.9	1.0	1.0
Dividends	(5.6)	(6.2)	(6.9)
Share buyback	(0.6)	-	-
Construction cost, interest cost, working capital & others	(12.0)	(13.3)	(13.9)
Capex	(8.0)	(10.0)	(11.0)
Tax	(6.9)	(7.8)	(8.5)
Net cash inflow / (outflow)	**20.7**	**21.7**	**23.3**
Additional cash dividends	(1.0)	(1.0)	(1.0)
Share buyback	(9.4)	(10.0)	(10.0)
Net cash inflow / (outflow)*	**10.3**	**(4.8)**	**5.9**
Net cash/ (Net debt) b/f	(15.1)	10.33	10.7
Net cash/ (Net debt) c/f	**(4.8)**	**5.9**	**18.2**

Source: Daiwa forecasts

*Note: * after adjusting for a HKD1bn rise in annual cash dividend and HKD10bn a year in share buyback (200m shares@HKD50/share)*

5. Valuation: room for the NAV discount to narrow

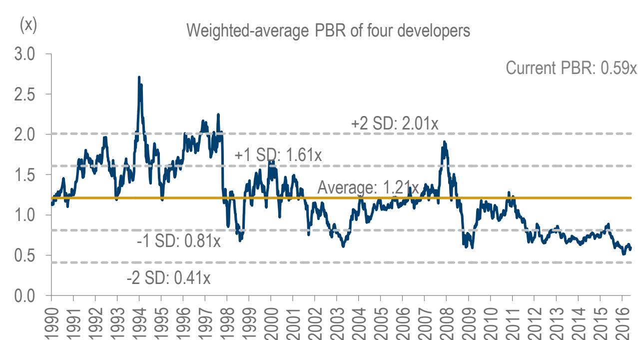
Why is there a "Hong Kong discount" and can CKP escape from it?

After the reorganisation in 2015, CKP has become one of the 2 largest property companies in Hong Kong, with a market cap of USD22bn, which makes it one of the major stocks in the global property field as well.

Has not escaped from the "Hong Kong discount"

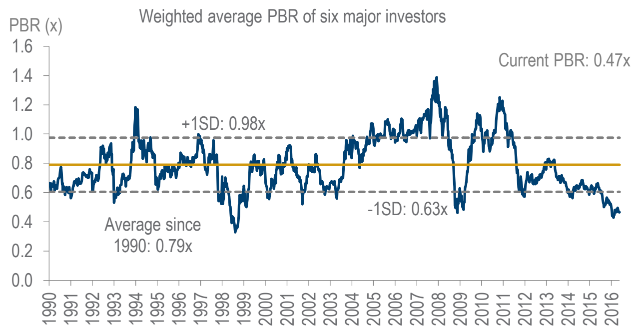
That said, CKP has not been able to escape the "Hong Kong discount" and is now trading at a 55% discount to NAV, similar to its Hong Kong peers. In our opinion, the NAV discount on Hong Kong property stocks is a sector-wide, rather than a company-specific, phenomenon. In Appendix 2, we put forward our perspective on why such a discount has existed and persisted. Our main conclusion is that a lack of sufficient confidence in how much the Hong Kong family property companies care about capital allocation and the interests of outside shareholders is one of the main contributing factors. While there could be biases and misconceptions in the global capital markets' perceptions about the Hong Kong family property companies, it appears that there has not been strong forces driving either investors or these companies to address such a discount – a situation that has been aggravated by the developments the Hong Kong stock market has been undergoing, as characterised by the secondary market not being able to develop as fast as its primary market (see Appendix 2 for details).

Major Hong Kong property developers: PBR



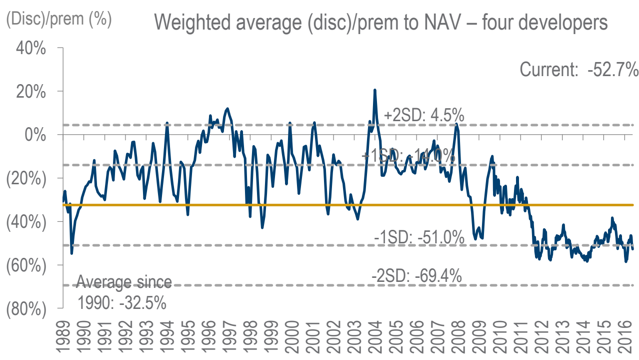
Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



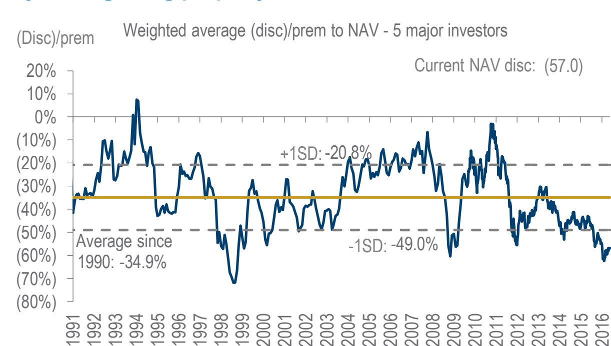
Source: Companies, Datastream, Daiwa

Major Hong Kong property developers: P/NAV



Source: Companies, Datastream, Daiwa estimates

Major Hong Kong property investors: P/NAV



Source: Companies, Datastream, Daiwa estimates

Nevertheless, we think Link REIT (823 HK, HKD46.4, Buy [1]) has shown that escaping from, or at least narrowing, such a Hong Kong discount is not inconceivable for specific companies. We think the strong balance sheets and recurrent income base of Hong Kong's property companies and their demonstrated willingness to pay higher and higher DPS should be factors that work in favour of the Hong Kong property companies over time. So is many Hong Kong property companies' demonstrated competence in terms of managing the real estate business as well as getting returns from their investing in China.

Cheung Kong group's reorganisation in January 2015 was a landmark event

Most important of all, we think the Cheung Kong Group reorganisation in early 2015 was a sign that the Cheung Kong Group has an awareness of the importance of being evaluated in the same way as others in the global capital markets, and that it has the will and determination to at least trying to address the discount in its equity market valuation.

In this report, we argue that the Cheung Kong group stands out from its peers in terms of its capital allocation mindset, and is a pioneer in the Hong Kong corporate sector in many respects. For example, it was the first to realise that it was cheaper to acquire British companies to get their land and management resources at a discount rather than having to pay market prices to buy the land on the open market, and it has done this since the 1970s. Meanwhile, it was also one of the pioneers in Hong Kong in terms of scaling up its China landbank in the mid-2000s, and sponsoring the development of the REITs. More recently, it has become a pioneer among the Hong Kong's largest property companies in that it was the first to introduce a share buyback scheme.

CKP is well-positioned to capitalise on the disconnect between physical property prices and share prices

In our opinion, one factor that augurs well for the prospects for a narrowing of the NAV discount of Hong Kong property stocks is that the values of physical market assets in Hong Kong are realisable and that opportunities could increase if more mainland corporations establish a presence in Hong Kong. In other words, we think there is a significant disconnect between the prices of physical property assets and the share prices of the Hong Kong property companies which own a significant portion of the most prime physical real estate property assets in Hong Kong.

However, historically, seldom do Hong Kong property companies capitalise on such opportunities to conduct some kind of "arbitrage" between these 2 markets ie, realising the property values in the physical market and then using such proceeds to buy stocks that are trading at a significant discount to the value of the physical property assets they own. In this regard, Link REIT can be considered one of the first examples of Hong Kong property companies pursuing a strategy of selling non-core assets at a premium to book value and then buying back shares/units that are trading at a discount to their book values. Actually, Sunlight REIT was the first property REIT in Hong Kong to articulate such a strategy. It did a unit buyback and sale of non-core assets in 2012 and has kept on buying back units, though perhaps not at a scale sufficient to catch the market's attention.

In all, we believe CKP has considerable credentials to see its NAV discount narrow. Our view is that a combination of paying more dividend/disposal of property assets and consistent share buyback is a credible way to narrow the NAV discount on Hong Kong property companies because:

1. It provides a way to capitalise on the disconnection between physical property prices and stock market valuation
2. It provides a mechanism to connect corporate balance sheets with equity valuation
3. It provides a way to advance the interest of minority shareholders

Among the major Hong Kong property companies, we see CKP as the one with the strongest resources and incentive to embark on share buybacks. Hence, we consider it a major stock to play on the theme of a potential narrowing of the "Hong Kong discount" in equity market valuations.

Along these lines, we think another issue to take note of is that from end-August 2016 onward, Real Estate will become a standalone sector in the Global Industry Classification Standard (GICS) used by the global financial community, rather than being included in Financials as it is currently. While we do not expect to see a major immediate reaction in the market once this change is adopted, we do believe that such a change will provide a boost to investor interest in the real estate sector. As Hong Kong property stocks are among the cheapest in the world, we expect that sooner or later there could be investors looking for ways to play the narrowing of the "Hong Kong discount" in the valuation of property stocks.

We also note that in global property, there are already a number of premier names in commercial property while the number of sizeable players in the business of developing residential property for sale is comparatively more limited. Given that CKP has a sizeable market capitalisation (over USD20bn) and that its differentiated business model has generated impressive returns to shareholders in the past, we do believe it has considerable credentials to be recognised as a more important stock among global property stocks over time, especially if it can keep on paying more dividends and doing more share buybacks.

We initiate coverage of CKP with a Buy (1) rating and TP of HKD71.0

And indeed we do see substantial scope for CKP's NAV discount to narrow. We assign an end-2016 NAV for CKP of HKD101.50 and in the following table we show the implied price per sq ft for each of the different asset classes and the breakdown by geography. We put the total value of CKP's property assets at HKD373.5bn, which translates into HKD97.10/share. This is slightly below the valuation provided by DTZ in its valuation report dated February 2016, which gives a NAV for CKP's property assets (excluding the market value of the various REITs in which it has major stakes) of HKD98.60/share. After adding back the market value of CKP's stakes in various REITs and the net cash it is expected to have by end-2016, our end-2016E NAV for CKP is HKD101.50.

Based on a 30% discount (a level of discount we have applied to the leading players in Hong Kong property) to our end-2016E NAV of HKD101.50, our 12-month target price for CKP is HKD71.0. We initiate coverage with a Buy (1) rating.

CKP: Daiwa's breakdown of estimated end-2016 NAV

	Floor area (m sq ft)	Valuation Total (HKDm)	Per sq ft (HKD)	Per share (HKD)	No. of rooms	Value/ room (HKDm)
Investment properties						
HK	13.8	122,585	8,909	31.87		
China	1.8	5,140	2,927	1.34		
Singapore	-	-	-	-		
UK	0.08	304	3,850	0.08		
Bahamas	-	-	-	-		
	15.6	**128,029**	**8,210**	**33.29**		
Development properties						
HK	6.9	65,356	9,448	16.99		
China	161.7	105,260	651	27.37		
Singapore	0.4	874	2,340	0.23		
UK	5.8	7,625	1,317	1.98		
Bahamas	-	-	-	-		
	174.8	**179,115**	**1,025**	**46.57**		
Hotels & serviced suites						
HK	6.9	64,210	9,268	16.69	12,652	5.1
China	1.4	1,710	1,206	0.44	1,603	1.1
Singapore	-	-	-	-	-	-
UK	-	-	-	-	-	-
Bahamas	1.0	445	433	0.12	1,271	0.3
	9.4	**66,365**	**7,080**	**17.3**	**15,526**	**4.3**
GAV - all property assets	**199.7**	**373,508**	**1,870**	**97.1**		
Interests in listed REITs & ARA		11,485		3.0		
Net cash		5,238		1.36		
NAV		**390,232**		**101.5**		

Breakdown of GAV by country	Valuation Total (HKDm)	Per share (HKD)	% share
HK	252,151	65.6	67.5%
China	112,110	29.1	30.0%
Singapore	874	0.2	0.2%
UK	7,929	2.1	2.1%
Bahamas	445	0.1	0.1%
	373,508	**97.1**	**100%**

Breakdown of HK investment properties by property	Floor area (m sq ft)	Valuation Total (HKDm)	Per sq ft (HKD)	Per share (HKD)	Monthly rent per sq ft (on GFA, HKD)	Gross cap rate
Whampoa Garden	1.71	13,164	7,680	3.42	32	5.0%
1881 Heritage	0.14	7,476	53,333	1.94	200	4.5%
Cheung Kong Center	1.26	34,111	27,000	8.87	90	4.0%
China Building	0.26	4,830	18,667	1.26	70	4.5%
Hutchison House	0.50	9,403	18,667	2.44	70	4.5%
The Center	1.22	22,739	18,667	5.91	70	4.5%
Tower1,TheHarbourfront	0.43	4,031	9,333	1.05	35	4.5%
Tower2,TheHarbourfront	0.43	4,024	9,333	1.05	35	4.5%
Others	7.80	22,808	2,925	5.93		
	13.76	**122,585**	**8,909**	**31.87**		

Source: Daiwa estimates

Risks to our call

More than 95% of CKP's earnings and NAV come from Hong Kong and China, and hence they would be subject to macroeconomic, political, as well as other risks related to these two areas. China has been attempting to transform its economy from one driven mainly by fixed-asset investment in the past into one which is driven more by private consumption and investment, but it remains to be seen whether such transition can succeed. In the meantime, China's economic growth momentum is expected to be slower than before during its transitional period. Since over 60% of CKP's earnings come from property sales, earnings would be affected by volatility and weaknesses in the residential property markets in both Hong Kong and China.

CKP's residential landbank in Hong Kong has been shrinking as it has not bought major residential sites in Hong Kong in recent years. Whether CKP can replenish its Hong Kong residential landbank at attractive prices remains to be seen, and the entry of mainland players into the Hong Kong residential property market would likely increase the competition in the land market. That said, CKP's current residential landbank in Hong Kong – amounting to some 7m sq ft GFA – is still the second largest in Hong Kong, and CKP's property sales profit from China has surpassed that of Hong Kong in 2015. Meanwhile, rental properties previously owned by Hutchison will be contributing to CKP's rental income from June 2015 onwards.

Appendix 1: the development of Cheung Kong's property businesses

Now starting on Chapter 4

Got into the property market at just the right time

Cheung Kong entered the property industry at favourable time in the industry's development in Hong Kong, ie, in the late-1960s, after the banking crisis and the 1967 riots had led to a collapse in the territory's property market. Essentially, what it did was use all the capital and profit it had made from its manufacturing business to buy land and develop its residential property development business prior to its listing in Hong Kong in 1972.

Cheung Kong was far from the largest property developer in Hong Kong at the time of its listing. However, in subsequent years, it has been the fastest growing in terms of market capitalisation and profits, and has been one of the largest players since the late-1970s. It has subsequently become the largest property developer in Hong Kong since the property market crash in the early-1980s. We break down the development of the Cheung Kong group's property business into 3 phases, and believe it has entered the fourth chapter in its development.

Chapter 1 (1960s-1990): ambitious plans to push forward as a Hong Kong developer

A pioneer in forging deals with entities that own land

While Cheung Kong's first 3 decades in the property business was already quite a long time ago, we see them as the formative years for the company, helping to shape its development and illustrating some of the major principles by which Cheung Kong runs its property business.

In retrospect, we think 3 factors contributed significantly to Cheung Kong's rapid rise in the property industry, from its moderate start in the 1960s to being the industry's largest developer by the end of the 1990s. One is that we think Cheung Kong was a pioneer in terms of forging co-operation deals with entities that owned land but did not have the relevant property-development expertise or want to assume the risks related to the business. The Hong Kong property development segment has always been a capital-intensive one, in our view, and hence a company's capital base can be a significant constraint in the development of property companies in the city. In this light, the deals forged by Cheung Kong with the landowners represented an innovative way to cope with these constraints, allowing the group to have access to landbank resources beyond what its capital base could support, and yet it did not have to assume too much risk.

Has been using the stock market to finance its land acquisitions

Other than the ability to make attractive land acquisition deals, another factor which has contributed is Cheung Kong's ability to make good use of its equity value to strengthen its land acquisition capability, and for these to form a virtuous cycle. In the 1970s, as Cheung Kong had already demonstrated that it could forge attractive deals with landowners, its shares were valued highly in the stock market and the group made use of this to raise funds to finance further land acquisitions. This in turn helped Cheung Kong's share price and further strengthened its financial capability to acquire land, which resulted in it becoming a pioneer in Hong Kong in terms of it acquiring British companies, and we view this as the third major factor propelling the rapid rise of Cheung Kong during this period.

In our opinion, the aspect that distinguishes Cheung Kong the most from its peers is its investors and its capital allocation mindset, which was probably one of the main reasons why it was one of the first companies in Hong Kong to identify that it was much cheaper and safer to buy land through listed companies than via land auctions. As such, by the late-'70s, it had become the pioneer in Hong Kong in terms of acquiring the British companies with significantly underutilised landbank resources that were trading at significant discounts to their NAVs.

Has worked on 4 mega projects since the late-1980s

In retrospect, one of the main factors underpinning Cheung Kong's dominance as the city's largest residential developer in the 1980s was its harvest of the landbank it had acquired by taking over various British companies (such as Green Island Cement, Hutchison

Whampoa, HK Electric, etc) and JVs with landowners (such as Shell, China Resources Group). These were the main sources of land for the Cheung Kong group's four mega residential estates – Serenity Garden, Laguna City, South Horizons, Kingswood Villa – completed in Hong Kong from the late 80s.

Chapter 2 (1991-2003): focusing on revitalising Hutchison and then leveraging on Hutchison to achieve further growth

Only buys land when the margin of safety is deemed high enough

If the development of the Cheung Kong group's property business over 1960s-1990 can be defined as an "ambitious push forward", its strategy since 1990 can be defined as one in which it put a greater emphasis on revitalising Hutchison and then leveraging on it (delisted) to achieve further growth, in our view.

In our opinion, part of the reason for the change was that the scale of Cheung Kong's residential property business had become very large by the late-1980s but the opportunities for acquiring land by taking over companies and JVs with land owners had become increasingly difficult to find. Meanwhile, the group was reluctant to chase land in public auctions, with rising prices, which in our view reflects its decision to buy only when the margin of safety becomes high enough.

In hindsight, we do wonder whether Cheung Kong should have focused more on building up its rental portfolio during this period. However, the payback profile for its property investments is quite backend-loaded, meaning that the returns it generates were far lower than the property sales would have been in the initial years and, traditionally, Cheung Kong's expertise has laid more in executing large-scale residential property projects than managing commercial properties. These are probably the reasons why Cheung Kong has not invested as much in building up its commercial properties as its peers.

Leveraged on Hutchison to drive its business growth

In any case, our read is that in the early-1990s, Cheung Kong chose to invest more in Hutchison shares (Cheung Kong acted as what we would call the underwriter of Hutchison shares when it raised funds through share placements in 1991 and 1992). Moreover, it also took stakes in smaller players and, at one point, had parked over HKD10bn in the shares and convertible bonds of these various smaller listed companies. Our read is that this was motivated by it waiting for attractive enough investment opportunities for land, which we see as one of the main principles by which Cheung Kong runs its property business (ie, to be disciplined and wait for the right entry point). When the opportunities are not attractive enough, it preferred to park its cash in what it saw as more attractive investments, including Hutchison shares and the building up of Cheung Kong Infrastructure in the early 1990s.

The investment in Hutchison Whampoa began paying off in the early-2000s

In any case, our read is that Cheung Kong's decision to raise its stake in Hutchison in the early-1990s (to help it to recapitalise and reposition) did pay off, as Hutchison entered a period of robust earnings growth from about 1993 until the end of 1999, when it started investing in building up the 3 Group in UK and Europe, which generated growing dividends for Cheung Kong. From the mid-1990s, Hutchison Whampoa became an important partner in the development of Cheung Kong's property business, as Hutchison acted as its partner in various land acquisitions. In 1997, Cheung Kong's stake in Hutchison rose further as a result of the 1997 Cheung Kong group restructuring that resulted in, among other things, Cheung Kong monetising the value of its investments by building up Cheung Kong Infrastructure, which subsequently became a subsidiary under Hutchison.

Another point to note about Cheung Kong's development during this period, in our view, is its investment in the 2 hotel sites in Hunghom with a total GFA of 2.4m sq ft, and an average land cost of just HKD715/sq ft. This investment, together with its purchase of the Horizon Suite site in Ma On Shan, secured the group a sizeable hotel/hotel suite portfolio at a very low entry cost. As of today, these investments have helped CKP become the largest owner of hotel/hotel suites in Hong Kong, and we think the longer-term importance and significance of its hotel-suites business has yet to unfold fully.

In our opinion, the development of the hotel and suites business of CKP also helps illustrate an important point about CKP's property business model, which is that it has often been astute in identifying growth opportunities beyond the traditional boundaries of the property business and been able to secure low-cost entry. This has put it in good position to create value for shareholders, offering upside potential that is often unavailable to the traditional property companies.

Chapter 3 (2004-14): early mover in pushing forward its Hong Kong residential property business and Mainland presence

Active buyer of land since the land auction resumed in 2004

One area Cheung Kong missed out on during in its development over 1991-2003 is that it did not invest that much in expanding its rental-property portfolio. That said, the investment property business is one where the returns are rather backend-loaded and which requires tying up tens of billions of dollars for years. In hindsight, Cheung Kong group opted to use its capital to raise its stake in Hutchison Whampoa and build up Cheung Kong Infrastructure, as well as its hotel business, all of which have generated reliable recurrent income and did not significantly raise the group's overall risk profile.

Whatever the merits of the path Cheung Kong group chose, we think it has remained in a strong financial position over the course of the downturn in the Hong Kong economy since 4Q97 and the residential-property sector, and that it has the financial flexibility to return to expanding its net landbank once the property market starts emerging from the recession. Indeed, the group has seized such an opportunity. When the land auctions resumed in 2004, Cheung Kong group was the most active bidder and won the first site in Ma On Shan. In subsequent years, it was one of the largest buyers of land via tenders from the Hong Kong government and MTRC, a trend that continued until about 2012. Cheung Kong is currently still the largest residential developer in Hong Kong in terms of the size of its landbank.

The group has been rapidly scaling up its China landbank since 2004

Around the same year, we saw the company become much more active in buying land in the Mainland, and its Mainland landbank has ballooned from 0.3m sq ft before 2004 to some 200m sq ft in 2016. We see this move as being very important to the company as land was still relatively cheap during that period. As is the case for most of the other businesses that the Cheung Kong group was engaged in, the timing of its entry point has always been important, and our read is that the group's entry into China was at a favourable time, which should underpin its China earnings and cash-flow going forward.

Meanwhile, during this period the group also started building its landbank in London and Singapore, and it sponsored the establishment of some REITs in Hong Kong, such as Fortune REIT, Prosperity REIT and the Hui Xin REIT.

In our opinion, one of the main achievements of Cheung Kong during this period was that it built up its presence in China and Singapore while bringing down net gearing and lifting its dividends.

Chapter 4 (2014-): leveraging on enlarged resources, significant monetisation in the years ahead

Reorganisation has significantly strengthened CKP's recurrent income and China landbank

In our opinion, the Cheung Kong group reorganisation in early 2015 was a milestone event in the development of the Cheung Kong group's property business, giving it immediate access to a rental portfolio generating over HKD4bn in gross rental income annually, which would otherwise have taken it many years and over HKD80bn of capital to build. Meanwhile, the merger with Hutchison Property has effectively doubled its China landbank at a time when the group's platform for executing many property projects in many cities in China has started to mature and when the central government has started focusing on helping the property sector to clear inventory.

Long-term prospects rest on how effectively it deploys the proceeds of property sales in the coming years

In our opinion, CKP is now well placed to monetise the returns from its early and decisive purchases of land in Hong Kong and China, and should raise over HKD160bn from property sales in the coming years. How well it deploys this capital will go a long way to determining its prospects in the coming years, in our view.

Appendix 2: What are the reasons given for the "Hong Kong discount"?

And can CKP escape it?

We think the basic reason for the emergence of the "Hong Kong discount" is that, back in the early days (1960s-1990s), Hong Kong's listed property companies seemed ready to use equity capital to finance their business expansion and landbank acquisitions. This was because their capital and recurrent income bases at that time were much smaller, and because it was harder to secure long-term borrowing at low rates given the structure of the lending market in Hong Kong at that time. As such, many Hong Kong property companies were ready to raise equity capital when the opportunity arose and even when their share prices were quite far from their NAVs. As such, it was hard for these stocks to sustain valuations in line with, or even close to, their NAVs. We think this is the reason the "Hong Kong discount" came into being.

The Hong Kong property cycle has not been in sync with the global one

We note that during these years, the US and UK property markets were not in particularly good shape and the AUM of the global property and REIT funds were much less than they are today. Our read is that many of the investors active in the Hong Kong market at that time were country funds focusing on Hong Kong and/or China, or regional funds focusing on Asia, which tended to see property more as a major asset class for rotation rather than adopting a bottom-up valuation perspective of the individual Hong Kong property stocks. Against this backdrop, and given that the physical property markets in Hong Kong have always seemed shrouded in uncertainty and risk, the "Hong Kong discount" has persisted.

In retrospect, the Hong Kong property cycle has been driven more by its own dynamics rather than being closely aligned with the global property cycle. Hence, when the US and UK/Commonwealth property markets gradually entered a boom phase from the mid-1990s, Hong Kong entered its worst-ever downturn in 4Q97-mid-2003. Our read is that with the boom in property markets in the US, UK/Commonwealth countries, the size of the US and global property and REIT sector (along with the AUM of the global property and global REIT funds) also continued to expand. However, Hong Kong property stocks did not benefit much from the initial ramp-up in the AUM of the global property funds and global REIT funds as the Hong Kong property market was in bad shape during 4Q97-mid-2003.

The Hong Kong model is not the same as that globally

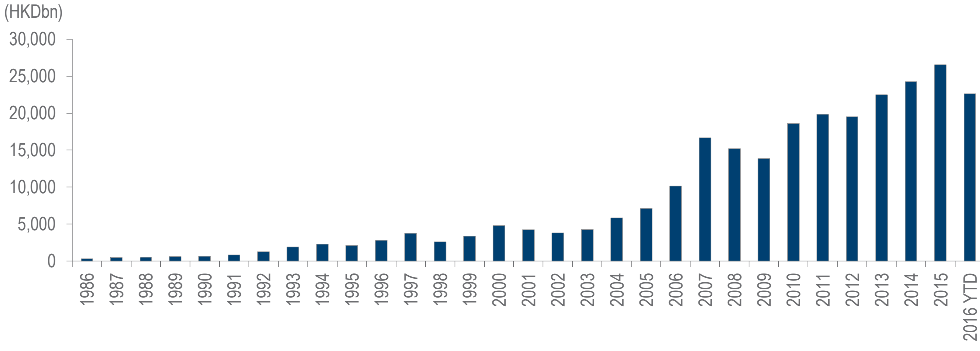
Moreover, the business model and structure of Hong Kong's property sector does not readily fit into the global landscape – in Hong Kong, most property companies are traditional property companies owned by the city's well established families, while overseas, many property companies are REITs or companies with professional management. While property companies/ REITs overseas tend to focus on specific segments where they have the most expertise, their Hong Kong counterparts tend to be more like property conglomerates with exposure to a range of property asset classes.

As such, while the prolonged low-interest-rate environment has boosted the development and valuations of the property and REIT sectors in the US/UK/Europe (it is not uncommon for the premier names in global property to trade at close to NAV or even at a premium), this has not had much of a positive spillover effect for the Hong Kong property stocks.

The structural changes in the Hong Kong stock market have been a contributing factor

In our opinion, another factor contributing to the "Hong Kong discount" is the structural change in the Hong Kong stock market, from a local-centric one in the 1990s and before, to an increasingly China-centric one from the mid-1990s. This structural change in the Hong Kong stock market has boosted significantly the market cap of the Hong Kong stock market, from HKD1tn back in 1992 (before the first H share, Tsingtao Brewery, was listed in 1993) to HKD31tn in 2Q15 and about HKD24tn currently. This expansion was fuelled by the many mega IPOs for Mainland companies, which for many years made Hong Kong the world's No.1 market in terms of funds raised from IPOs.

Hong Kong stock market: market capitalisation growth



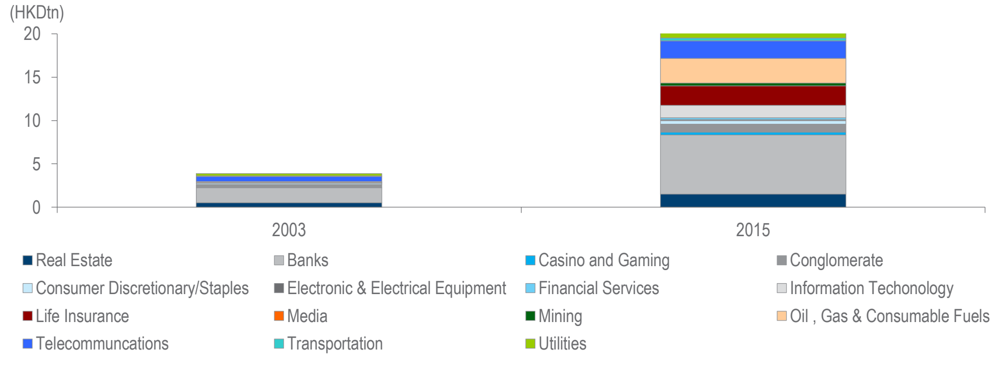
Source: Bloomberg, Daiwa
Note: 2016 YTD as at 23 May 2016

The development of the secondary market has not kept up with the development of the primary one

While this structural change boosted the market capitalisation of the Hong Kong stock market and the city's importance as a financial centre, it had some consequences for the valuations of companies in Hong Kong. This is because we believe the development of the secondary market – in terms of the number of investors and the AUM dedicated to secondary market trading – has been a gradual process, such that it has probably lagged behind the development of the primary market in Hong Kong.

As a consequence, from 2H03, while the Hong Kong property market bounced back, the property stocks have had to compete in a much deeper pool of stocks. Before 1997, property was such an important sector in Hong Kong that nearly all Hong Kong funds needed some property exposure. However, from the 2000s, many new sectors have emerged, including Macau Gaming, China banks, China property, Chinese Insurance, Oil and Gas, Internet, all of which are suitable candidates for a portfolio. As such, we saw a situation where a lot more companies were competing for the pool of AUM, which was not growing at a pace comparable to the expansion in Hong Kong's market capitalisation.

Market capitalisation: HSI constituents



Source: Bloomberg, Daiwa

In our view, the Hong Kong stock market is now at a transition point where the pace of development of its secondary market has not been able to catch up with its primary market, and one consequence is that some sectors have been neglected for an extended period of time. And since the Lehman crisis in 2008, funds have been flowing from equities into bonds, and from emerging markets into developed markets — yet another challenge for all stocks.

The Hong Kong property companies as a whole don't need equity capital

Meanwhile, the Hong Kong property companies are financially strong and do not need to raise equity capital, especially as many of them have seen their recurrent rental incomes double or more in the past 10 years, as bank borrowing has been readily available and interest rates are low. We also think many of them have tended to see a listing as a way to gain access to equity capital when they need it (this has often happened in the past only when they decided to commit to some large investment where the payback period was

long). In face of the "Hong Kong discount", it appears that some of the property companies have chosen to undertake rights issues or bonus warrants, which may not lead to the dilution of their existing shareholders (if they subscribe for the new shares in the rights issue) but are likely to appear odd to many international investors.

In many ways the Hong Kong property companies don't fit the global template for property companies

Admittedly, in terms of management style and strategy, as well as the allocation of capital within the company and dividend policy, the model employed by many Hong Kong property companies does not readily fit into the global template for property companies. In other words, global investors probably need to spend extra time to understand the Hong Kong property companies. It can take a lot of time and effort to understand the background and motivations of each of the major controlling families in the Hong Kong property market, and hence it is understandable that some investors would prefer a typical property company or REIT in the West, ie, one with a more clearly defined business model and dividend policy. In this light, we think it is understandable that the Hong Kong property companies tend to trade on different valuation parameters. At the same time, it seems there are no compelling forces on either side to bring these valuation parameters into line.

Compounding the situation, in our view, is that the book values and NAV of the Hong Kong property companies have been growing robustly since 2H03. As such, the Hong Kong property stocks need an expanding pool of investing funds dedicated to them to ensure that they can maintain their valuations. One reason why the "Hong Kong discount" has persisted and widened in recent years is that the NAV, book values and recurrent incomes of the Hong Kong property stocks have continued to rise, but this has not been reflected in their stock prices.

Despite its relatively low valuation, the Hong Kong property sector is far from small in terms of market cap…

We note also that while the valuations of Hong Kong property companies are comparatively low, the market caps of the Hong Kong property companies are not small, as they are among some of the most profitable property companies in the world and own some of the most valuable property assets. As such, the equity market capitalisation of Hong Kong's listed real-estate companies stands at some USD200bn currently (while owning underlying assets that are worth USD400bn or more). Of course, the fact that the 2 tidal waves (low US interest rates and Mainland consumers coming to Hong Kong) have been on the retreat in recent months, alongside concerns about the macroeconomic backdrop to the Hong Kong property market, have not helped Hong Kong's property stocks either.

Property securities listed 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	3,846	45.25	22.4	30.2	2,683	15.6
16 HK	SHK Properties	2,895	86.95	32.4	56.9	1,248	14.0
12 HK	Henderson Land	3,307	44.45	18.9	72.6	905	5.2
83 HK	Sino Land	6,166	11.40	9.0	54.1	2,832	4.2
20 HK	Wheelock	2,032	32.95	8.6	11.9	1,790	7.6
17 HK	New World	9,388	7.11	8.6	44.4	5,221	4.8
				100.0			**51.3**
Property Investors							
4 HK	Wharf	3,031	41.35	16.1	60.0	1,211	6.4
1972 HK	Swire Properties	5,850	19.90	15.0	82.0	1,053	2.7
HKL SP	HK Land	2,353	USD6.08	14.3	50.2	1,172	7.1
101 HK	Hang Lung Properties	4,497	14.22	8.2	55.2	2,017	3.7
14 HK	Hysan Development	1,047	31.60	4.3	41.6	611	2.5
683 HK	Kerry Properties	1,443	19.30	3.6	59.9	579	1.4
41 HK	Great Eagle	668	28.75	2.5	65.2	232	0.9
				64.0			**24.8**
REITs							
823 HK	Link REIT	2,243	46.40	13.4	0.2	2,239	13.4
87001 HK	Hui Xian REIT	5,399	3.10	2.6	48.2	2,799	1.3
2778 HK	Champion REIT	5,786	3.97	3.0	63.4	2,120	1.1
778 HK	Fortune REIT	1,893	8.56	2.1	28.0	1,363	1.5
1881 HK	Regal REIT	3,257	1.90	0.8	75.0	814	0.2
405 HK	Yue Xiu REIT	2,845	4.27	1.6	63.6	1,037	0.6
435 HK	Sunlight REIT	1,638	4.12	0.9	31.6	1,120	0.6
1426 HK	Spring REIT	1,125	3.29	0.5	36.2	718	0.3
808 HK	Prosperity REIT	1,446	2.98	0.6	19.4	1,166	0.4
				25.3			**19.4**
Niche property companies							
878 HK	Soundwill	283	9.90	0.4	69.8	86	0.1
173 HK	K Wah International	2,840	3.75	1.4	52.3	1,354	0.7
497 HK	CSI Properties	10,037	0.25	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	4.32	0.7	59.4	546	0.3
488 HK	Lai Sun Development	30,159	0.10	0.4	62.0	11,446	0.1
				3.4			**1.4**
				192.6			**96.9**

Source: Bloomberg, Daiwa
Note: prices as of close on 23 May 2016

… but the disconnect between prices in the physical market and stock prices is real and large

All in all, our view is that the "Hong Kong discount" has persisted for a reason. Having said that, we still have to factor that there is a significant disconnect between the prices in the physical property market and the stock prices of the property companies in Hong Kong. In theory, when such a large disconnect exists, there tends to be corporate action (such as privatisations) or takeovers (by private equity firms, corporate raiders or other corporations) to capitalise upon it. However, the stringent privatisation rules in Hong Kong (where 10% of the minority shareholders' combined stake is enough to block any privatisation deal), and the existence of majority/close-to-majority family ownership, has prevented the aforementioned corporate actions from happening in the past.

That said, we believe this large disconnect is real and the Hong Kong property companies do have growing rental income and their book values and NAVs backed by the realisable values of their physical property assets. We also think that Hong Kong property companies have their own relative strengths, such as the fact they are financially strong and have low gearing.

The valuation achieved by Link REIT is an anomaly

One interesting development in the valuations of the Hong Kong property sector in the recent years is that Link REIT has achieved a much better valuation than any other property stock in Hong Kong, despite the market generally recognising that the property assets it owns are of lower quality compared with those of its major peers.

The Link REIT: PBR trend since IPO

Source: Company, Bloomberg, Daiwa

In our opinion, the case of the Link REIT illustrates that it is not inconceivable for the Hong Kong property companies to trade at valuations more in line with those of their global peers. Essentially, we think that the Link REIT indicates that the “Hong Kong discount” does not stem solely from property companies’ ownership of Hong Kong assets, but rather how the companies manage those assets, deploy their capital, set their dividend policies, and manage the interests and views of their shareholders. By extension, then, positive changes in these components should help to narrow the “Hong Kong discount”.

In this context, we think that what the Link REIT has been doing, such as realising NAV through the sale of non-core assets and then buying back units that are trading at a discount, is an alternative and feasible way (other than privatisation or a hostile takeover) of “arbitraging” between prices in the physical market and stock market.

Daiwa Capital Markets

Hang Lung Properties (101 HK)

Target price: **HKD23.70** (from HKD23.70)

Share price (23 May): **HKD14.22** | Up/downside: **+66.6%**

Buy (unchanged)

Long-term play on prime commercial property in China

- The sale of Long Beach should enhance earnings visibility in 2016
- HK is holding up, but it needs to ramp up malls in tier-2 cities
- Reiterate Buy (1) rating and HKD23.70 target price

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What's new: Hang Lung Properties (HLP) has sold about 227 units in The Long Beach (out of a total of 672 remaining units) in the recent weeks at an ASP of about HKD13,000/sq ft. This should improve earnings visibility for 2016 and provide it with the capital to fund the roll-over of China projects as well as a nurturing period for its malls in tier-2 cities.

What's the impact: Long Beach is still a high-margin project, as we estimate the total development cost for these units is only about HKD4,500/sq ft. At an ASP of HKD13,000/sq ft, we estimate full disposal of all the remaining units in Long Beach would bring in over HKD6bn in cash and over HKD4bn in profit.

Is there any future for modern malls in tier-2 cities? We think so. It is not uncommon for shopping malls to face problems in the initial years, but think these problems are fixable over time by experienced managers of retail properties. We believe that both opportunities and threats exist in the China retail property market but that the number of people who can afford mid-range products (which we define as per-ticket spending of CNY100-500) is on the rise in major Chinese cities.

Does HLP have the dedication and expertise to overcome the challenges faced by its malls outside of Shanghai? While it is a challenge for mall managers to attract consumers with spending power in China to visit and shop at its malls frequently, we believe HLP's track record in Shanghai and Hong Kong suggests that the group possesses retail management expertise, and it has been learning and improving. Meanwhile, it is important to bear in mind that HLP's new malls in tier-2 cities account for less than 20% of its annual gross rentals, and that the stock currently offers over a 5% dividend yield.

What we recommend: We see HLP as a credible and focused long-term play on the growth of the middle class and luxury consumption in China over time. We reaffirm our Buy (1) rating and 12-month TP of HKD23.70, based on a 40% discount applied to our end-2016E NAV of HKD39.50. The key risk to our call would be the company's inability to ramp up the sales performance of its malls in tier-2 cities.

How we differ: We believe the major Chinese cities can support at least 2 or more major malls and that there are not yet many proven players in this top-end segment of the market. This, however, may not yet be fully recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance

12-month range	13.32-26.30
Market cap (USDbn)	8.20
3m avg daily turnover (USDm)	12.93
Shares outstanding (m)	4,479
Major shareholder	Hang Lung Group (54.3%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	10,495	11,437	12,503
Operating profit (m)	7,829	9,086	10,321
Net profit (m)	5,346	6,406	7,449
Core EPS (fully-diluted)	1.194	1.430	1.663
EPS change (%)	21.9	19.8	16.3
Daiwa vs Cons. EPS (%)	6.9	27.0	38.4
PER (x)	11.9	9.9	8.6
Dividend yield (%)	5.3	5.3	5.4
DPS	0.750	0.750	0.770
PBR (x)	0.5	0.5	0.5
EV/EBITDA (x)	9.5	8.5	7.7
ROE (%)	4.1	4.9	5.5

Source: FactSet, Daiwa forecasts

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Gross rental income (HKDm)	5,161	6,098	6,642	7,216	7,751	8,311	8,894	9,607
Rental EBIT (HKDm)	4,194	4,896	5,286	5,589	5,704	6,171	6,642	7,243
Property sales profit (HKDm)	2	3,063	1,511	7,419	844	1,217	2,031	2,646

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Rental income	5,161	6,098	6,642	7,216	7,751	8,911	9,794	10,607
Property sales	3	1,274	2,496	9,814	1,197	1,584	1,643	1,896
Other Revenue	0	0	0	0	0	0	0	0
Total Revenue	**5,164**	**7,372**	**9,138**	**17,030**	**8,948**	**10,495**	**11,437**	**12,503**
Other income	231	2,774	829	922	1,104	1,165	1,202	1,268
COGS	(968)	(1,630)	(2,301)	(3,995)	(2,400)	(3,107)	(2,764)	(2,614)
SG&A	(512)	(626)	(642)	(644)	(655)	(724)	(789)	(836)
Other op.expenses	0	0	0	0	0	0	0	0
Operating profit	**3,915**	**7,890**	**7,024**	**13,313**	**6,997**	**7,829**	**9,086**	**10,321**
Net-interest inc./(exp.)	(93)	(348)	(437)	(698)	(1,041)	(714)	(728)	(743)
Assoc/forex/extraord./others	98	105	96	75	59	83	87	91
Pre-tax profit	**3,920**	**7,647**	**6,683**	**12,690**	**6,015**	**7,198**	**8,445**	**9,669**
Tax	(815)	(944)	(1,088)	(2,146)	(1,184)	(1,298)	(1,480)	(1,644)
Min. int./pref. div./others	(364)	(525)	(545)	(522)	(444)	(554)	(559)	(576)
Net profit (reported)	**2,741**	**6,178**	**5,050**	**10,022**	**4,387**	**5,346**	**6,406**	**7,449**
Net profit (adjusted)	**2,741**	**6,178**	**5,050**	**10,022**	**4,387**	**5,346**	**6,406**	**7,449**
EPS (reported)(HKD)	**0.613**	**1.380**	**1.128**	**2.238**	**0.979**	**1.194**	**1.430**	**1.663**
EPS (adjusted)(HKD)	**0.613**	**1.380**	**1.128**	**2.238**	**0.979**	**1.194**	**1.430**	**1.663**
EPS (adjusted fully-diluted)(HKD)	**0.613**	**1.380**	**1.128**	**2.238**	**0.979**	**1.194**	**1.430**	**1.663**
DPS (HKD)	**0.710**	**0.740**	**0.750**	**0.760**	**0.750**	**0.750**	**0.750**	**0.770**
EBIT	**3,915**	**7,890**	**7,024**	**13,313**	**6,997**	**7,829**	**9,086**	**10,321**
EBITDA	**3,915**	**7,890**	**7,024**	**13,313**	**6,997**	**7,829**	**9,086**	**10,321**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	3,920	7,647	6,683	12,690	6,015	7,198	8,445	9,669
Depreciation and amortisation	25	27	29	31	33	35	36	38
Tax paid	(735)	(1,018)	(1,088)	1,741	(1,650)	(1,298)	(1,480)	(1,644)
Change in working capital	620	554	314	740	(486)	795	810	832
Other operational CF items	(73)	171	266	543	897	541	549	558
Cash flow from operations	**3,757**	**7,381**	**6,204**	**15,745**	**4,809**	**7,271**	**8,360**	**9,453**
Capex	(5,982)	(8,088)	(9,274)	(6,620)	(7,380)	(5,579)	(6,890)	(6,920)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	124	129	134	136	140	145	148	149
Cash flow from investing	**(5,858)**	**(7,959)**	**(9,140)**	**(6,484)**	**(7,240)**	**(5,434)**	**(6,742)**	**(6,771)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	10,896	0	0	0	0	0	0	0
Dividends paid	(3,014)	(3,183)	(3,582)	(3,313)	(3,582)	(3,805)	(4,029)	(4,253)
Other financing CF items	(392)	(415)	(430)	(442)	(317)	(470)	(475)	(478)
Cash flow from financing	**7,490**	**(3,598)**	**(4,012)**	**(3,755)**	**(3,899)**	**(4,275)**	**(4,504)**	**(4,731)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**5,389**	**(4,177)**	**(6,947)**	**5,506**	**(6,330)**	**(2,438)**	**(2,886)**	**(2,049)**
Free cash flow	(2,225)	(707)	(3,070)	9,125	(2,571)	1,692	1,470	2,533

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	27,202	36,025	34,321	39,946	31,289	36,476	34,880	32,150
Inventory	5,963	6,109	5,695	4,046	3,830	2,580	1,320	320
Accounts receivable	1,983	1,270	2,865	1,916	1,173	2,130	2,260	2,340
Other current assets	0	452	0	0	0	0	0	0
Total current assets	**35,148**	**43,856**	**42,881**	**45,908**	**36,292**	**41,186**	**38,460**	**34,810**
Fixed assets	107,646	122,955	138,354	146,048	146,470	155,672	162,801	167,946
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	1,888	1,053	1,045	1,223	1,256	1,295	1,320	1,390
Total assets	**144,682**	**167,864**	**182,280**	**193,179**	**184,018**	**198,153**	**202,581**	**204,146**
Short-term debt	4,500	1,113	1,657	5,657	4,693	5,760	5,890	5,960
Accounts payable	3,430	4,811	5,977	7,906	6,806	8,165	8,320	8,450
Other current liabilities	1,196	392	633	1,581	501	1,623	1,650	1,672
Total current liabilities	**9,126**	**6,316**	**8,267**	**15,144**	**12,000**	**15,548**	**15,860**	**16,082**
Long-term debt	12,236	28,623	33,322	29,441	28,078	34,636	35,796	35,046
Other non-current liabilities	8,396	8,947	9,524	9,591	9,048	10,589	11,078	9,946
Total liabilities	**29,758**	**43,886**	**51,113**	**54,176**	**49,126**	**60,773**	**62,734**	**61,074**
Share capital	4,472	4,477	4,479	4,479	4,479	4,479	4,479	4,479
Reserves/R.E./others	105,247	113,451	120,055	127,848	124,510	126,051	128,427	131,623
Shareholders' equity	**109,719**	**117,928**	**124,534**	**132,327**	**128,989**	**130,530**	**132,906**	**136,102**
Minority interests	5,205	6,050	6,633	6,676	5,903	6,850	6,940	6,970
Total equity & liabilities	**144,682**	**167,864**	**182,280**	**193,179**	**184,018**	**198,153**	**202,581**	**204,146**
EV	58,430	63,452	70,982	65,519	71,076	74,461	77,438	79,517
Net debt/(cash)	**(10,466)**	**(6,289)**	**658**	**(4,848)**	**1,482**	**3,920**	**6,806**	**8,856**
BVPS (HKD)	**24.535**	**26.341**	**27.816**	**29.544**	**28.799**	**29.143**	**29.673**	**30.387**

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	(57.2)	42.8	24.0	86.4	(47.5)	17.3	9.0	9.3
EBITDA (YoY)	(54.3)	101.5	(11.0)	89.5	(47.4)	11.9	16.1	13.6
Operating profit (YoY)	(54.3)	101.5	(11.0)	89.5	(47.4)	11.9	16.1	13.6
Net profit (YoY)	(58.9)	125.4	(18.3)	98.5	(56.2)	21.9	19.8	16.3
Core EPS (fully-diluted) (YoY)	(61.8)	125.1	(18.3)	98.4	(56.2)	21.9	19.8	16.3
Gross-profit margin	81.3	77.9	74.8	76.5	73.2	70.4	75.8	79.1
EBITDA margin	75.8	107.0	76.9	78.2	78.2	74.6	79.4	82.5
Operating-profit margin	75.8	107.0	76.9	78.2	78.2	74.6	79.4	82.5
Net profit margin	53.1	83.8	55.3	58.8	49.0	50.9	56.0	59.6
ROAE	2.8	5.4	4.2	7.8	3.4	4.1	4.9	5.5
ROAA	2.1	4.0	2.9	5.3	2.3	2.8	3.2	3.7
ROCE	3.4	5.5	4.4	7.8	4.1	4.5	5.1	5.6
ROIC	3.2	6.2	4.7	8.3	4.2	4.6	5.2	5.7
Net debt to equity	n.a.	n.a.	0.5	n.a.	1.1	3.0	5.1	6.5
Effective tax rate	20.8	12.3	16.3	16.9	19.7	18.0	17.5	17.0
Accounts receivable (days)	122.9	80.5	82.6	51.2	63.0	57.4	70.1	67.1
Current ratio (x)	3.9	6.9	5.2	3.0	3.0	2.6	2.4	2.2
Net interest cover (x)	42.1	22.7	16.1	19.1	6.7	11.0	12.5	13.9
Net dividend payout	115.8	53.6	66.5	34.0	76.6	62.8	52.4	46.3
Free cash flow yield	n.a.	n.a.	n.a.	14.3	n.a.	2.7	2.3	4.0

Source: FactSet, Daiwa forecasts

Company profile

Hang Lung Properties (HLP) is the property arm of Hang Lung Group, which is one of the most established property developers in Hong Kong. In the 1990s, it invested in 2 major commercial property projects in Shanghai, which later became among the most popular commercial property assets in Shanghai and China. Since the early 2000s, it has been pursuing a strategy of focusing on the commercial property sector in China, and has subsequently acquired 8 major sites outside Shanghai. It now has a stated strategy to transform itself into a leading player in commercial property in Greater China.

HLP: performance of HK portfolio in 2015

Property	Gross rental Income YoY (%)	Retail sales YoY (%)	Occupancy (%)
HK commercial portfolio			
Causeway Bay portfolio	+15%	+12%	nd
Grand Plaza, Mongkok	+14%	+6%	nd
Central portfolio	+11%	nd	nd
Amoy Plaza, Kowloon Bay	+9%	+9%	nd
Kornhill Plaza, Quarry Bay	+6%	+6%	nd
Overall	**+8%**	**+7%**	**98%**
HK office portfolio			
Central portfolio	+7%	na	nd
Hang Lung Centre, Causeway Bay	+12%	na	96%
Mongkok portfolio	+11%	na	94%
Overall	**+9%**	**na**	**95%**
Residential & Serviced Apartments			
Kornhill Serviced Apartments, Quarry Bay	+3%	na	nd
High-end apartments	+10%	na	nd
Overall	**+7%**	**na**	**nd**

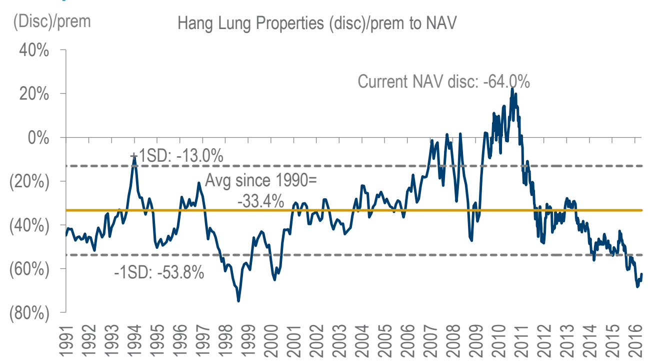
Source: Company, Daiwa
Note: nd = not disclosed

Comments on different segments of customers for malls in China

Per ticket spending	Comments
CNY100-200	The mall needs to have very large volume to do well if it focuses on this market segment.
CNY200-500	We believe that over 20 Chinese cities should see a growing number of consumers falling into this category.
CNY500-5,000	Whether a mall can have a critical mass of customers in this segment will be a deciding factor for performance
CNY5,000-50,000	Probably only a few cities can have critical mass for this segment.
Over CNY50,000	This type of spending is fading and may not return for a long time.

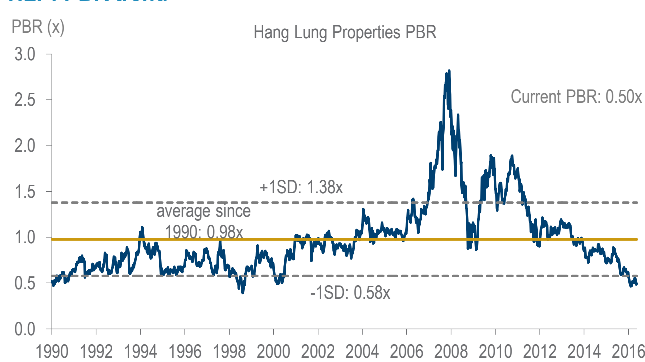
Source: Daiwa

HLP: price/NAV trend



Source: Datastream, Daiwa estimates

HLP: PBR trend



Source: Datastream, Daiwa

HLP: operating performance of its various properties

Property	City	Year of opening	Gross rental income (HKDm) 1H13	2H13	1H14	2H14	1H15	2H15	YoY chg	HoH chg	2013	2014	2015	YoY chg
Palace 66	Shenyang	2010	75	85	80	86	84	86	0%	2%	160	166	170	2%
Parc 66	Jinan	2011	189	178	171	165	168	167	1%	-1%	367	336	335	0%
Forum 66 (mall)	Shenyang	2012	138	144	142	141	127	111	-21%	-13%	282	283	238	-16%
Forum 66 (office)	Shenyang	2015	na	na	na	na	9	35	na	4x	na	Na	44	na
Center 66 (mall)	Wuxi	2013	na	77	145	144	125	92	-36%	-27%	77	289	217	-25%
Center 66 (office)	Wuxi	2014	na	na	na	4	30	49	12x	63%	na	4	79	20x
Riverside 66	Tianjin	2014	na	na	na	63	121	120	90%	-1%	na	63	241	4x
Grand Gateway 66	Shanghai	2001	523	545	570	587	607	589	0%	-3%	1,068	1,157	1,196	3%
Plaza 66 (mall)	Shanghai	2002	384	388	402	413	452	433	5%	-4%	772	815	885	9%
Plaza 66 (office)	Shanghai	2002	392	408	423	380	395	389	2%	-2%	800	803	784	-2%
Olympia 66	Da,ain	2015	na	na	na	na	na	5	na	na	na	Na	5	na
HK portfolio	HK	Various	1,521	1,591	1,633	1,667	1,744	1,813	8%	4%	3,112	3,300	3,557	8%

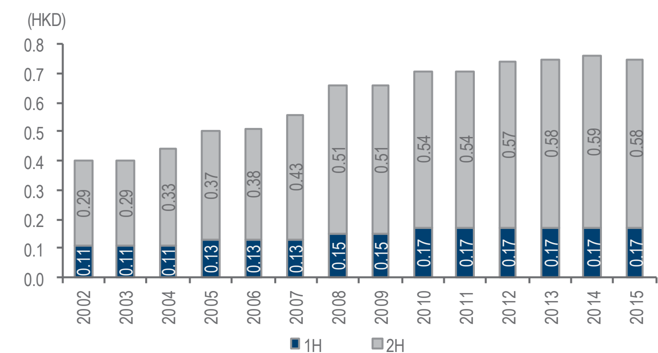
Property	Occupancy (%) 1H13	2H13	1H14	2H14	1H15	2H15	YoY chg	HoH chg	Retail sales YoY growth (%) 2013	2014	1H15	2015
Palace 66	90%	90%	90%	88%	84%	90%	+2pp	+6pp	10%	12%	10%	2%
Parc 66	95%	85%	85%	85%	90%	88%	+3pp	-2pp	14.83	-2%	-1%	-2%
Forum 66 (mall)	98%	98%	93%	93%	88%	87%	-6pp	-1pp	15%	2%	-5%	-3%
Forum 66 (office)	na	na	na	na	30%*	42%	na	+12pp	na	na	na	na
Center 66 (mall)	na	95%	95%	91%	80%	72%	-19pp	-8pp	na	48%	Flat	-3%
Center 66 (office)	na	na	na	29%	60%*	70%	+41pp	+10pp	na	na	na	na
Riverside 66	na	na	na	87%	88%	86%	-1pp	-2pp	na	na	na	na
Grand Gateway 66	100%	100%	100%	99%	98%	97%	-2pp	-1pp	Flat	3%	6%	1%
Plaza 66 (mall)	100%	100%	97%	97%	100%	97%	Flat	-3pp	Flat	-4%	1%	1%
Plaza 66 (office)	95%	97%	95%	96%	96%	98%	+2pp	+2pp	na	na	na	na
Olympia 66	na	na	na	na	na	54%	na	na	na	na	na	na
HK portfolio	nd	nd	nd	nd	nd	nd	na	na	nd	nd	nd	nd

Source: Company, Daiwa
*Note: nd = not disclosed; * = committed occupancy*

HLP: rental income from Hong Kong and China

Source: Company

HLP: DPS history



Source: Company

Daiwa Capital Markets

Henderson Land (12 HK)

Target price: **HKD60.80** (from HKD60.80)

Share price (23 May): **HKD44.45** | Up/downside: **+36.7%**

5 4 3 2 **1**

Buy (unchanged)

Delivering returns to shareholders

- 2015 dividend is more than double the 2010 level
- DPS growth underpinned by growing rental and sales pipeline
- Reiterating Buy (1) and TP of HKD60.80

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What's new: Henderson has continued acquiring units in old buildings in urban areas over the past few months despite the challenging market, according to various reports in the *Hong Kong Economic Times*. This bodes well for the company's DPS, which we think could continue to rise over 2016-18 – its 2015 payout was more than double the 2010 level, due to 4 consecutive 1-for-10 bonus issues since 2012, and the continued rise in its nominal DPS (up 32% YoY for 2015).

What's the impact: Growing DPS underpinned by growing gross rentals, which have risen 5-fold since 2005 to reach HKD8.2bn for 2015. With continued asset enhancement for its suburban malls and the completion of new rental properties, the company should have considerable capability to expand its DPS in 2016-18.

Breakthrough achieved in realisation of farmland value? Henderson has already paid the land premium for a small Yuen Long site with the government through the "Pilot Scheme for Arbitration on Land Premium". This could pave the way for a notable increase in the amount of farmland Henderson can convert. In any case, the government's determination to develop new areas could lead to Henderson making progress in its attempt to realise the value of its farmland.

Commitment to delivering returns to shareholders. We see the 32% rise in its 2015 DPS and Henderson chairman Lee Shau Kee's address to analysts during the latest results briefing as a sign of the company's commitment to delivering shareholder returns. The company declared several special dividends in the 1990s when it started monetising the value of its decades-long investment in Land Exchange Entitlements. Greater transparency and growing dividends should be constructive in terms of reducing the NAV discount on Henderson's shares, in our view.

What we recommend: We reaffirm our Buy (1) rating and 12-month TP of HKD60.80, based on a 30% discount applied to our end-2016E NAV of HKD86.80/share. Key risk: a major deterioration in the Hong Kong/China economies.

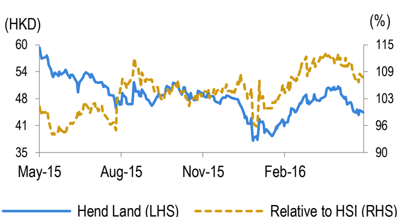
How we differ: We believe Henderson has demonstrated considerable commitment and determination to delivering returns to all shareholders and that this is backed up by its growing rental income and expanding property sales pipeline. This however may not yet be fully recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	37.70-59.31
Market cap (USDbn)	18.89
3m avg daily turnover (USDm)	21.15
Shares outstanding (m)	3,301
Major shareholder	Lee Shau Kee (72.3%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	33,707	37,250	39,860
Operating profit (m)	10,262	11,663	13,155
Net profit (m)	12,820	14,550	16,100
Core EPS (fully-diluted)	3.884	4.408	4.877
EPS change (%)	16.6	13.5	10.7
Daiwa vs Cons. EPS (%)	24.4	37.8	43.8
PER (x)	11.4	10.1	9.1
Dividend yield (%)	3.3	3.4	3.6
DPS	1.450	1.520	1.600
PBR (x)	0.6	0.5	0.5
EV/EBITDA (x)	9.3	8.0	7.0
ROE (%)	5.0	5.5	5.8

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales profit (HKDm)	2,186	2,306	2,952	3,376	3,980	4,456	4,995	5,522
Rental EBIT (HKDm)	2,620	3,107	3,670	5,754	6,303	6,807	7,283	7,725

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales	9,692	8,708	15,743	15,466	15,690	23,856	26,254	27,956
Rental income	3,920	4,494	4,994	5,445	5,589	5,920	6,540	6,890
Other Revenue	1,576	2,390	2,552	2,460	3,336	3,931	4,456	5,014
Total Revenue	**15,188**	**15,592**	**23,289**	**23,371**	**24,615**	**33,707**	**37,250**	**39,860**
Other income	0	0	0	0	0	0	0	0
COGS	(8,418)	(8,167)	(14,508)	(13,590)	(12,669)	(20,292)	(22,390)	(23,416)
SG&A	(1,045)	(1,060)	(1,200)	(1,268)	(1,298)	(1,489)	(1,523)	(1,590)
Other op.expenses	(1,178)	(1,066)	(1,456)	(1,557)	(2,078)	(1,664)	(1,674)	(1,699)
Operating profit	**4,547**	**5,299**	**6,125**	**6,956**	**8,570**	**10,262**	**11,663**	**13,155**
Net-interest inc./(exp.)	(1,169)	(1,239)	(957)	(1,429)	(1,442)	(1,230)	(1,320)	(1,390)
Assoc/forex/extraord./others	3,548	4,167	5,102	6,594	6,334	7,205	7,680	7,950
Pre-tax profit	**6,926**	**8,227**	**10,270**	**12,121**	**13,462**	**16,237**	**18,023**	**19,715**
Tax	(1,310)	(1,005)	(1,244)	(2,707)	(1,905)	(3,279)	(3,331)	(3,459)
Min. int./pref. div./others	(56)	(124)	(88)	(122)	(548)	(138)	(142)	(156)
Net profit (reported)	**5,560**	**7,098**	**8,938**	**9,292**	**11,009**	**12,820**	**14,550**	**16,100**
Net profit (adjusted)	**5,560**	**7,098**	**8,938**	**9,292**	**11,009**	**12,820**	**14,550**	**16,100**
EPS (reported)(HKD)	**2.471**	**2.987**	**3.312**	**3.130**	**3.330**	**3.884**	**4.408**	**4.877**
EPS (adjusted)(HKD)	**2.471**	**2.987**	**3.312**	**3.130**	**3.330**	**3.884**	**4.408**	**4.877**
EPS (adjusted fully-diluted)(HKD)	**2.471**	**2.987**	**3.312**	**3.130**	**3.330**	**3.884**	**4.408**	**4.877**
DPS (HKD)	**1.100**	**1.060**	**1.060**	**1.100**	**1.120**	**1.450**	**1.520**	**1.600**
EBIT	**4,547**	**5,299**	**6,125**	**6,956**	**8,570**	**10,262**	**11,663**	**13,155**
EBITDA	**4,699**	**5,463**	**6,296**	**7,134**	**8,762**	**10,460**	**11,862**	**13,359**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	6,926	8,227	10,270	12,121	13,462	16,237	18,023	19,715
Depreciation and amortisation	152	164	171	178	192	198	199	204
Tax paid	(973)	(1,020)	(1,120)	(2,436)	(1,715)	(2,951)	(2,998)	(3,113)
Change in working capital	268	3,277	1,290	8,808	8,925	9,025	9,250	9,580
Other operational CF items	46	234	(1,194)	(1,597)	(1,418)	(2,143)	(2,308)	(2,400)
Cash flow from operations	**6,419**	**10,882**	**9,417**	**17,073**	**19,446**	**20,366**	**22,166**	**23,986**
Capex	(8,546)	(8,620)	(9,274)	(9,273)	(18,876)	(15,865)	(16,859)	(18,410)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	4,379	5,320	1,350	1,480	1,490	1,510	1,530	1,530
Cash flow from investing	**(4,167)**	**(3,300)**	**(7,924)**	**(7,793)**	**(17,386)**	**(14,355)**	**(15,329)**	**(16,880)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	10,000	0	0	0	0	0	0	0
Dividends paid	(2,362)	(2,362)	(2,575)	(2,939)	(4,073)	(4,547)	(4,767)	(5,018)
Other financing CF items	(1,567)	(1,651)	(1,251)	(1,881)	(1,930)	(2,018)	(2,151)	(2,225)
Cash flow from financing	**6,072**	**(4,013)**	**(3,826)**	**(4,820)**	**(6,003)**	**(6,565)**	**(6,918)**	**(7,243)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**8,324**	**3,569**	**(2,333)**	**4,460**	**(3,943)**	**(554)**	**(81)**	**(137)**
Free cash flow	(2,127)	2,262	143	7,800	570	4,501	5,307	5,576

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	19,364	14,390	15,858	12,022	14,512	14,468	15,418	15,418
Inventory	68,204	7,882	6,449	5,460	4,820	4,250	3,360	3,250
Accounts receivable	4,495	5,814	7,453	8,520	8,371	9,030	9,310	9,560
Other current assets	8,433	74,166	79,388	80,104	81,556	84,569	86,459	88,453
Total current assets	**100,496**	**102,252**	**109,148**	**106,106**	**109,259**	**112,317**	**114,547**	**116,681**
Fixed assets	92,771	101,072	108,872	119,705	128,597	132,633	137,094	144,519
Goodwill & intangibles	516	415	409	318	300	321	345	362
Other non-current assets	68,687	77,818	85,685	90,851	98,113	100,010	102,465	104,360
Total assets	**262,470**	**281,557**	**304,114**	**316,980**	**336,269**	**345,281**	**354,451**	**365,922**
Short-term debt	19,699	2,826	7,418	13,590	10,216	7,560	7,582	7,582
Accounts payable	9,030	15,265	15,890	17,304	19,098	18,125	16,345	16,468
Other current liabilities	798	1,404	2,111	1,346	2,990	3,045	3,068	3,091
Total current liabilities	**29,527**	**19,495**	**25,419**	**32,240**	**32,304**	**28,730**	**26,995**	**27,141**
Long-term debt	36,041	44,371	43,580	29,112	38,503	41,669	42,678	42,815
Other non-current liabilities	6,977	7,790	7,115	12,411	9,193	9,352	9,434	9,520
Total liabilities	**72,545**	**71,656**	**76,114**	**73,763**	**80,000**	**79,751**	**79,107**	**79,476**
Share capital	4,738	4,830	5,398	52,010	52,345	52,345	52,345	52,345
Reserves/R.E./others	180,598	200,382	218,004	186,140	198,902	208,025	217,789	228,871
Shareholders' equity	**185,336**	**205,212**	**223,402**	**238,150**	**251,247**	**260,370**	**270,134**	**281,216**
Minority interests	4,589	4,689	4,598	5,067	5,022	5,160	5,210	5,230
Total equity & liabilities	**262,470**	**281,557**	**304,114**	**316,980**	**336,269**	**345,281**	**354,451**	**365,922**
EV	123,855	112,185	107,313	99,965	98,386	97,525	95,325	93,688
Net debt/(cash)	**36,376**	**32,807**	**35,140**	**30,680**	**34,207**	**34,761**	**34,842**	**34,979**
BVPS (HKD)	**78.003**	**86.369**	**82.772**	**80.212**	**76.000**	**78.876**	**81.834**	**85.191**

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	114.2	2.7	49.4	0.4	5.3	36.9	10.5	7.0
EBITDA (YoY)	56.9	16.3	15.2	13.3	22.8	19.4	13.4	12.6
Operating profit (YoY)	59.7	16.5	15.6	13.6	23.2	19.7	13.6	12.8
Net profit (YoY)	10.3	27.7	25.9	4.0	18.5	16.5	13.5	10.7
Core EPS (fully-diluted) (YoY)	6.7	20.9	10.9	(5.5)	6.4	16.6	13.5	10.7
Gross-profit margin	44.6	47.6	37.7	41.9	48.5	39.8	39.9	41.3
EBITDA margin	30.9	35.0	27.0	30.5	35.6	31.0	31.8	33.5
Operating-profit margin	29.9	34.0	26.3	29.8	34.8	30.4	31.3	33.0
Net profit margin	36.6	45.5	38.4	39.8	44.7	38.0	39.1	40.4
ROAE	3.2	3.6	4.2	4.0	4.5	5.0	5.5	5.8
ROAA	2.3	2.6	3.1	3.0	3.4	3.8	4.2	4.5
ROCE	2.0	2.1	2.3	2.5	2.9	3.3	3.6	4.0
ROIC	1.7	2.0	2.1	2.0	2.6	2.8	3.1	3.4
Net debt to equity	19.6	16.0	15.7	12.9	13.6	13.4	12.9	12.4
Effective tax rate	18.9	12.2	12.1	22.3	14.2	20.2	18.5	17.5
Accounts receivable (days)	108.0	120.7	104.0	124.7	125.2	94.2	89.9	86.4
Current ratio (x)	3.4	5.2	4.3	3.3	3.4	3.9	4.2	4.3
Net interest cover (x)	3.9	4.3	6.4	4.9	5.9	8.3	8.8	9.5
Net dividend payout	44.5	35.5	32.0	35.1	33.6	37.3	34.5	32.8
Free cash flow yield	n.a.	1.5	0.1	5.3	0.4	3.1	3.6	3.8

Source: FactSet, Daiwa forecasts

Company profile

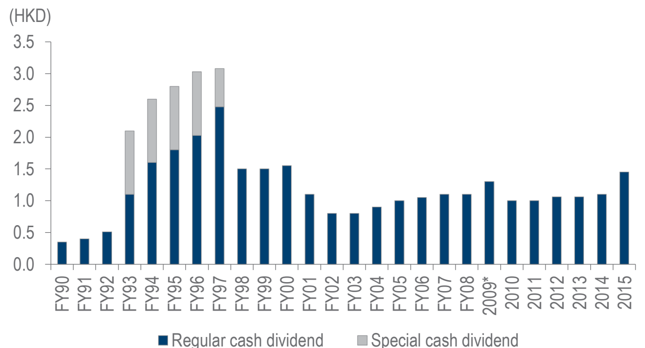
Henderson Land is one of the largest property companies in Hong Kong and has diversified investments in the residential-, office- and retail-property sectors. It is the largest holder of agricultural land in Hong Kong currently and also the largest shareholder in HK and China Gas as well as Miramar Hotel and HK Ferry. In recent years, Henderson Land has been increasing its investment in China property, and has a landbank of more than 100m sq ft in the country currently.

Henderson Land's harvesting time: end-2015 vs. end-2010

	2010	End-2015
Old buildings	Pre-sales not yet started	Profit from 4 projects booked in 2015
	6 projects with 100% ownership (0.3m sq ft)	17 projects with 100% ownership (1.5m sq ft); 28 projects with over 80% ownership (2.4m sq ft)
Farmland	Highly uncertain as to when or how they could be converted	Has settled the land premium for a small project via the pilot land premium arbitration scheme, which could become a model for many more
		The government plans to have finished Phase 1 land exchange procedures by the end of 2016 (Henderson has a GFA of about 0.8m sq ft available for land exchange (could be developed into GFA of up to 4.4m sq ft) and about 2m sq ft of GFA that the government paid cash for to the group
Contingent landbank	Uncertain development timeline	Both North Point office and Yau Tong Bay projects are in the final stages of land premium negotiations
Sites from land tender	No sites available for development	Sites in Sheung Shui and Tuen Mun on track for pre-sale in 12-24 months
Hong Kong rental income	Few bright spots other than IFC. Annual gross rental income was HKD4,398m in 2010	Major AEI work carried out or to be done on suburban malls and offices, plus contribution from new projects. Gross rental of HKD6,404m in 2015
Dividends from HK China Gas	HKD911m in 2010	HKD1.5bn in 2015
China rental income	HKD477m in a year	HKD1.75bn in 2015
Annual contract sales from China property	Below HKD1bn	HKD7.5bn in 2015
China property sales profits	Below HKD50m in 2010	HKD631m in 2015

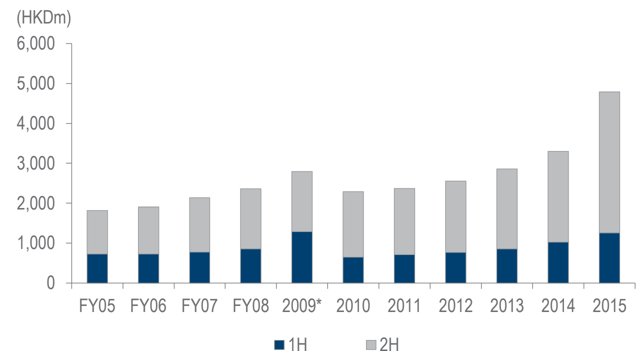
Source: Daiwa

Henderson Land: historical DPS**



Source: Company
*Note: *for the 18 months to 31 Dec 2009 (company's year-end date was changed in 2009 from Jun to Dec)*
***Actual cash DPS declared, before adjusting for 1:10 bonus issue in 2012, 2013, and 2014*

Henderson Land: dividends paid since 2005



Source: Company
*Note: *for the 18 months to 31 Dec 2009 (company's year-end date was changed in 2009 from Jun to Dec)*

Henderson Land: acquisition of old buildings in urban areas

	2010	2011	2012	2013	2014	2015
No. of old building projects						
100% ownership secured	6	13	14	14	13	17
80 -100% ownership secured	17	24	18	17	27	28
20 - 80% ownership secured	45*	47*	37	41	40	34
	68*	**84***	**69**	**72**	**80**	**79**
Attributable GFA of old building projects (m sq ft)						
100% ownership secured	0.3	0.9	1.1	0.9	1.3	1.5
80 -100% ownership secured	1.5	1.9	1.6	2.2	2.1	2.4
20 - 80% ownership secured	5.5*	5.2*	4.2	3.8	2.7	2.1
	7.2*	**8.0***	**6.9**	**6.9**	**6.1**	**5.9**

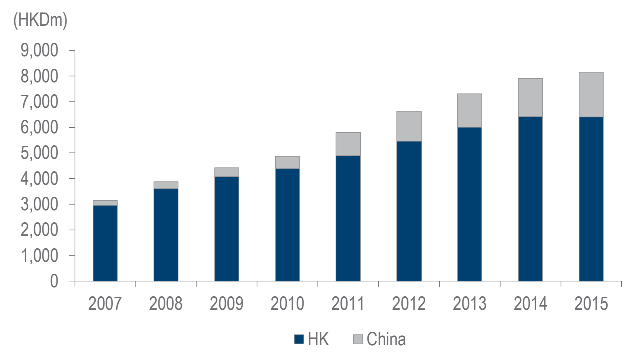
Source: Company
*Note: *include all projects with less than 20% ownership secured*

Henderson Land: major remarks by chairman Lee Shau Kee during the 2015 final results analyst meeting

On privatisation	"I already own over 72% of it…I am not going to privatise. They have supported me for years. Think we should share the ups and downs together...Don't want to profit from them."
On restructuring	"Some people have said that if I distribute out HK China Gas, then our share price will surge. I am not planning to distribute HK China Gas. I would rather pay more dividends and provide more transparency; to let people see more clearly…"
On dividends	"Henderson Land's dividend in recent years has been lower than it used to be. Now we are bringing it back to its average of the last 20 years."
On buying more Henderson shares	".I already own over 72% … I am interested but I'm almost close to the maximum level."

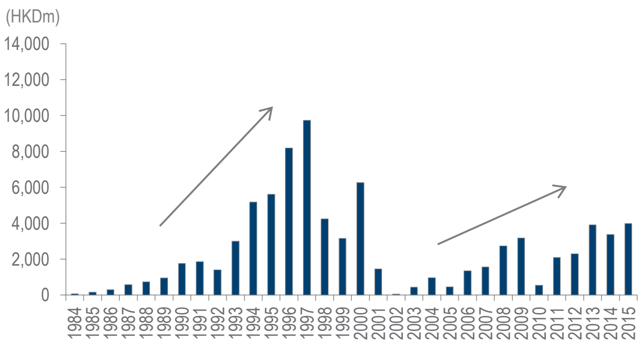
Source: Daiwa

Henderson Land: gross rental income



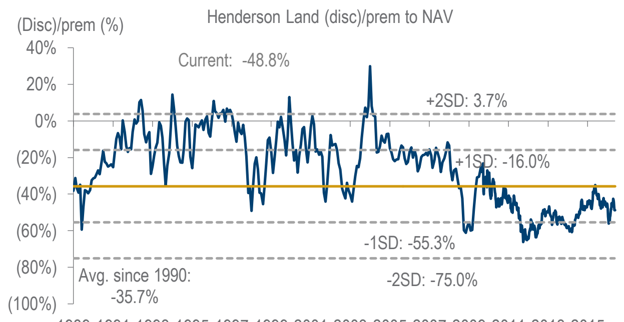
Source: Company, Daiwa

Henderson Land: property sales profit



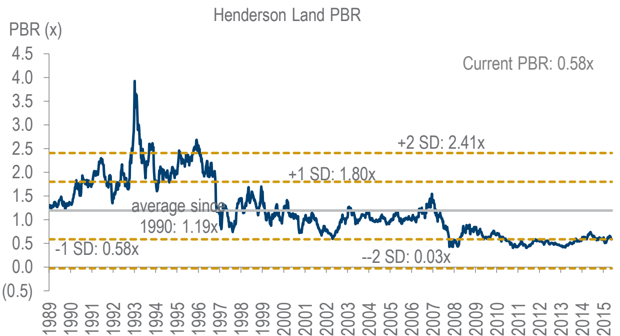
Source: Company, Daiwa

Henderson Land: price/NAV



Source: Datastream, Daiwa forecasts

Henderson Land: PBR



Source: Company, Datastream, Daiwa

Henderson Land: KPIs

	1H11	2H11	1H12	2H12	1H13	2H13	1H14	2H14	1H15	2H15
BVPS (HKD)	68.31	71.12	73.23	77.24	80.12	82.77	85.12	79.38	81.92	76.00
Gross rental income (HKDm)	2,769	3,036	3,231	3,397	3,586	3,721	3,854	4,050	4,027	4,125
- from HK (HKDm)	2,326	2,563	2,675	2,791	2,942	3,062	3,146	3,278	3,169	3,235
- from China (HKDm)	418	498	556	606	644	659	708	772	858	890
Sales and pre-sales in China (HKDm)	903	1,002	1,647	4,901	4,012	3,303	1,834	3,369	3,452	3,838
No. of old bldg projects	82	84	85	69	69	72	72	80	81	79
GFA of old bldg projects (m sq ft)	7.9	8.0	8.2	6.9	7.1	6.9	6.9	6.1	6.0	5.9
Net debt (HKDm)	34,649	36,890	36,382	35,205	31,984	38,344	31,171	37,420	33,064	40,317
Net debt to equity (%)	19.5%	19.9%	19.1%	17.2%	15.0%	17.2%	13.6%	15.7%	13.5%	16.0%
HK landbank (m sq ft)										
Properties held for/under development	10.2	10.2	10.1	10.4	10.1	13.7	13.1	13.0	13.6	13.4
Stock of unsold properties	0.8	0.7	0.5	0.4	0.5	0.8	0.9	0.9	0.7	0.9
Completed investment properties (incl. hotel)	10.2	10.2	10.1	10.1	10.2	10.1	10.1	9.9	10.0	10.1
	21.2	21.1	**20.7**	**20.9**	**20.8**	**24.6**	**24.1**	**23.8**	**24.3**	**24.4**
China landbank (m sq ft)										
Properties held for/under development	1H11	2H11	147.7	140.3	138.7	136.1	130.6	126.1	122.1	116.7
Stock of unsold properties	68.31	71.12	1.4	1.2	0.9	1.2	1.6	2.5	2.1	2.9
Completed investment properties	2,769	3,036	6.9	6.4	6.6	6.6	7.3	7.3	7.3	7.3
	2,326	2,563	**156.0**	**147.9**	**146.2**	**143.9**	**139.5**	**135.9**	**131.5**	**126.9**
Agricultural landbank in HK (m sq ft)	418	498	42.4	42.8	43.0	42.5	42.6	44.5	44.5	45.0

Source: Company

Daiwa
Capital Markets

Daiwa
Capital Markets

Daiwa Capital Markets

Hongkong Land (HKL SP)

Target price: **USD8.50** (from USD8.50)

Share price (23 May): **USD6.08** | Up/downside: **+39.8%**

5 4 3 2 1

Buy
(unchanged)

Riding on Central as a commercial hub

- Concerns regarding office demand in Central have not materialised
- Modest incremental demand would boost Central office rents
- Reiterating Buy (1) call and 12-month TP of USD8.50

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What's new: Hongkong Land's (HKL) Interim Management Statement for 1Q16 highlighted that "office rental reversion remains positive" and vacancy in its Central portfolio fell to 3.3% from 3.4% at end-2015, which we think bodes well for its rental outlook in the coming years.

What's the impact: Concerns that office demand would dry up have not materialised. Office demand among Mainland financial firms has continued into 2016. The China Government is pursuing reforms across the breadth of its financial sector (including bonds, commodities, currency and equities), which should mean that office demand among Mainland firms could be more sustainable than the stock market and media expectations. This is likely to benefit offices in Central first, and we think HKL will benefit given its status as the largest office landlord in Central.

Investor focus on multi-floor office demand from MNCs could be misguided, as we believe the pattern of office demand in Hong Kong changed in 2015, with the bulk of it coming from the gradual expansion of existing tenants/newcomers. We note that the corporate profit tax take in Hong Kong reached a new high of HKD135bn in 2015 and that nearly all the new office spaces completed since 2004 have been more or less taken up, which we think suggests that office demand in Hong Kong has been more solid than the market had thought. Further, we are not overly concerned about the consolidation of the investment banking sector as this has been an ongoing trend for several years and this sector does not account for a very large proportion of Grade A offices in Central (less than 10%). As such, it may be that the market is unduly concerned about the impact of this trend on HKL's Central office portfolio.

Gradual build-up of HKL's presence in China/Southeast Asia is beginning to bear fruit, with contract sales for its residential properties in China rising since 2013. This should result in a pipeline of new projects for completion in the years ahead.

What we recommend: We reaffirm our Buy (1) rating and 12-month TP of USD8.50, based on a 30% discount applied to our end-2016E NAV of USD12.10. The key risk to our call on HKL: a major contraction in office demand in Central and Singapore.

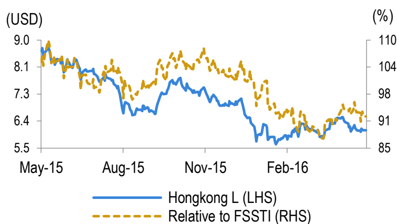
How we differ: We believe that the office segment is currently the strongest and healthiest within the Hong Kong property market. This, however, may have yet to be recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	5.62-8.74
Market cap (USDbn)	14.30
3m avg daily turnover (USDm)	18.51
Shares outstanding (m)	2,353
Major shareholder	Jardine Matheson (50.0%)

Financial summary (USD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	1,711	1,876	1,977
Operating profit (m)	979	1,088	1,197
Net profit (m)	876	990	1,128
Core EPS (fully-diluted)	0.372	0.421	0.479
EPS change (%)	(3.2)	13.0	13.9
Daiwa vs Cons. EPS (%)	(3.5)	4.4	17.2
PER (x)	16.3	14.4	12.7
Dividend yield (%)	3.3	3.5	3.6
DPS	0.200	0.210	0.220
PBR (x)	0.5	0.5	0.5
EV/EBITDA (x)	12.3	11.0	9.8
ROE (%)	3.0	3.4	3.8

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Gross rental income (USDm)	700	746	811	843	851	901	985	1,027
Size of completed investment properties in HK (m sq ft)	4.8	4.9	4.9	4.9	4.9	4.9	4.9	4.9
Size of completed investment properties outside HK (m sq ft)	2.8	3.4	3.3	3.3	3.3	4.1	4.5	4.7

Profit and loss (USDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales	413	252	926	910	955	670	738	791
Rental income	700	746	811	843	851	901	985	1,027
Other Revenue	111	117	120	124	126	140	153	159
Total Revenue	**1,224**	**1,115**	**1,857**	**1,876**	**1,932**	**1,711**	**1,876**	**1,977**
Other income	4	5	11	14	63	0	0	0
COGS	(320)	(235)	(858)	(719)	(891)	(620)	(674)	(661)
SG&A	(74)	(84)	(91)	(102)	(107)	(110)	(112)	(117)
Other op.expenses	(2)	(2)	(2)	(2)	(2)	(2)	(2)	(2)
Operating profit	**832**	**799**	**917**	**1,067**	**995**	**979**	**1,088**	**1,197**
Net-interest inc./(exp.)	(67)	(61)	(64)	(69)	(74)	(87)	(94)	(96)
Assoc/forex/extraord./others	76	166	235	123	141	175	227	290
Pre-tax profit	**842**	**904**	**1,088**	**1,121**	**1,062**	**1,067**	**1,221**	**1,391**
Tax	(134)	(124)	(149)	(188)	(151)	(188)	(227)	(259)
Min. int./pref. div./others	(5)	(4)	(4)	(3)	(6)	(3)	(4)	(4)
Net profit (reported)	**703**	**776**	**935**	**930**	**905**	**876**	**990**	**1,128**
Net profit (adjusted)	**703**	**776**	**935**	**930**	**905**	**876**	**990**	**1,128**
EPS (reported)(USD)	**0.303**	**0.331**	**0.397**	**0.395**	**0.385**	**0.372**	**0.421**	**0.479**
EPS (adjusted)(USD)	**0.303**	**0.331**	**0.397**	**0.395**	**0.385**	**0.372**	**0.421**	**0.479**
EPS (adjusted fully-diluted)(USD)	**0.301**	**0.331**	**0.397**	**0.395**	**0.385**	**0.372**	**0.421**	**0.479**
DPS (USD)	**0.160**	**0.170**	**0.180**	**0.190**	**0.190**	**0.200**	**0.210**	**0.220**
EBIT	**832**	**799**	**917**	**1,067**	**995**	**979**	**1,088**	**1,197**
EBITDA	**833**	**802**	**919**	**1,070**	**997**	**981**	**1,090**	**1,199**

Cash flow (USDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	842	904	1,088	1,121	1,062	1,067	1,221	1,391
Depreciation and amortisation	2	2	2	2	2	2	2	2
Tax paid	(117)	(147)	(139)	(134)	(120)	(132)	(140)	(150)
Change in working capital	(336)	(453)	66	(251)	0	0	0	0
Other operational CF items	4	27	(33)	43	31	11	(34)	(80)
Cash flow from operations	**394**	**333**	**985**	**781**	**975**	**948**	**1,049**	**1,163**
Capex	(89)	(563)	(174)	(174)	(139)	(433)	(468)	(560)
Net (acquisitions)/disposals	(146)	(283)	(203)	263	0	0	0	0
Other investing CF items	0	0	0	0	0	0	0	0
Cash flow from investing	**(235)**	**(846)**	**(378)**	**88**	**(139)**	**(433)**	**(468)**	**(560)**
Change in debt	(125)	914	287	(91)	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	9
Dividends paid	(372)	(375)	(405)	(426)	(440)	(472)	(510)	(540)
Other financing CF items	213	(27)	46	(76)	(80)	(82)	(84)	(87)
Cash flow from financing	**(284)**	**512**	**(72)**	**(593)**	**(520)**	**(554)**	**(594)**	**(618)**
Forex effect/others	3	(0)	8	(15)	0	0	0	0
Change in cash	**(123)**	**(1)**	**543**	**262**	**316**	**(39)**	**(13)**	**(15)**
Free cash flow	304	(230)	811	607	836	515	581	603

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (USDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	968	982	1,406	1,663	1,569	1,740	1,780	1,810
Inventory	1,521	2,513	2,670	2,923	2,714	2,744	2,790	2,820
Accounts receivable	314	351	274	292	356	380	390	410
Other current assets	2	7	17	13	8	9	10	11
Total current assets	**2,804**	**3,854**	**4,367**	**4,891**	**4,647**	**4,873**	**4,970**	**5,051**
Fixed assets	22,535	23,499	23,602	23,722	24,991	25,376	25,799	26,179
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	3,684	4,432	5,027	5,020	4,734	4,796	4,863	5,121
Total assets	**29,024**	**31,785**	**32,996**	**33,633**	**34,372**	**35,045**	**35,632**	**36,351**
Short-term debt	58	365	712	289	169	305	313	340
Accounts payable	746	1,143	1,409	1,442	1,484	1,485	1,512	1,560
Other current liabilities	83	60	71	102	69	108	110	118
Total current liabilities	**887**	**1,567**	**2,192**	**1,832**	**1,722**	**1,898**	**1,935**	**2,018**
Long-term debt	3,269	3,891	3,719	4,031	3,741	3,814	3,859	3,877
Other non-current liabilities	104	143	185	171	189	205	210	214
Total liabilities	**4,260**	**5,601**	**6,097**	**6,034**	**5,652**	**5,917**	**6,004**	**6,109**
Share capital	234	235	235	235	235	235	235	235
Reserves/R.E./others	24,505	25,912	26,622	27,313	28,450	28,855	29,351	29,962
Shareholders' equity	**24,739**	**26,148**	**26,857**	**27,548**	**28,685**	**29,090**	**29,586**	**30,197**
Minority interests	25	37	42	50	35	38	42	45
Total equity & liabilities	**29,024**	**31,785**	**32,996**	**33,633**	**34,372**	**35,045**	**35,632**	**36,351**
EV	13,138	13,345	12,442	12,108	12,063	12,054	12,009	11,777
Net debt/(cash)	**2,359**	**3,273**	**3,025**	**2,657**	**2,341**	**2,379**	**2,392**	**2,407**
BVPS (USD)	**10.581**	**11.113**	**11.415**	**11.709**	**12.192**	**12.364**	**12.575**	**12.834**

Key ratios (%)

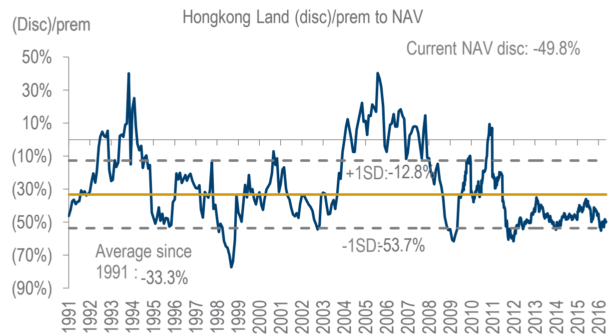
Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	(8.7)	(8.9)	66.6	1.0	3.0	(11.4)	9.6	5.4
EBITDA (YoY)	(5.6)	(3.8)	14.7	16.4	(6.8)	(1.6)	11.1	10.0
Operating profit (YoY)	(5.6)	(3.9)	14.7	16.4	(6.8)	(1.6)	11.1	10.0
Net profit (YoY)	(13.2)	10.3	20.4	(0.5)	(2.7)	(3.2)	13.0	13.9
Core EPS (fully-diluted) (YoY)	(12.6)	10.0	20.0	(0.5)	(2.7)	(3.2)	13.0	13.9
Gross-profit margin	73.8	78.9	53.8	61.7	53.9	63.8	64.1	66.6
EBITDA margin	68.1	71.9	49.5	57.0	51.6	57.3	58.1	60.6
Operating-profit margin	68.0	71.7	49.4	56.9	51.5	57.2	58.0	60.5
Net profit margin	57.5	69.6	50.3	49.6	46.8	51.2	52.8	57.1
ROAE	3.2	3.1	3.5	3.4	3.2	3.0	3.4	3.8
ROAA	2.6	2.6	2.9	2.8	2.7	2.5	2.8	3.1
ROCE	3.2	2.7	3.0	3.4	3.1	3.0	3.2	3.5
ROIC	2.9	2.4	2.7	3.0	2.8	2.6	2.8	3.0
Net debt to equity	9.5	12.5	11.3	9.6	8.2	8.2	8.1	8.0
Effective tax rate	15.9	13.7	13.7	16.8	14.2	17.6	18.6	18.6
Accounts receivable (days)	83.3	108.8	61.4	55.0	61.2	78.5	74.9	73.8
Current ratio (x)	3.2	2.5	2.0	2.7	2.7	2.6	2.6	2.5
Net interest cover (x)	12.5	13.1	14.3	15.5	13.4	11.3	11.6	12.5
Net dividend payout	52.8	51.3	45.3	48.1	49.4	53.7	49.9	45.9
Free cash flow yield	2.1	n.a.	5.7	4.2	5.8	3.6	4.1	4.2

Source: FactSet, Daiwa forecasts

Company profile

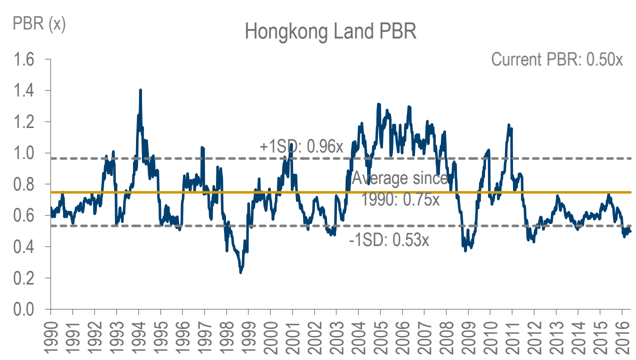
Hongkong Land (HKL) is a major commercial property landlord in Hong Kong, which owns 4.9m sq ft (NFA) of commercial properties in the heart of the Central district of Hong Kong. Since the mid-1990s, it has been pursuing a strategy to build up its presence in other major cities in Asia. Presently, it has 1.8m sq ft (NFA) of commercial properties in Singapore and 1.6m sq ft (NFA) in various major cities in Asia, such as Jakarta, Macau, Hanoi and Bangkok.

Hongkong Land: price/NAV



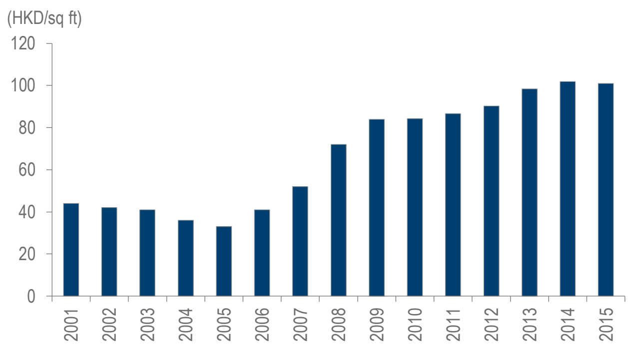
Source: Datastream, Daiwa estimates

Hongkong Land: PBR



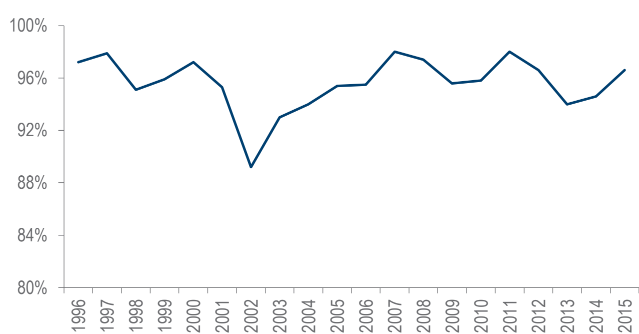
Source: Company, Datastream, Daiwa

Hongkong Land: Central office portfolio average rent



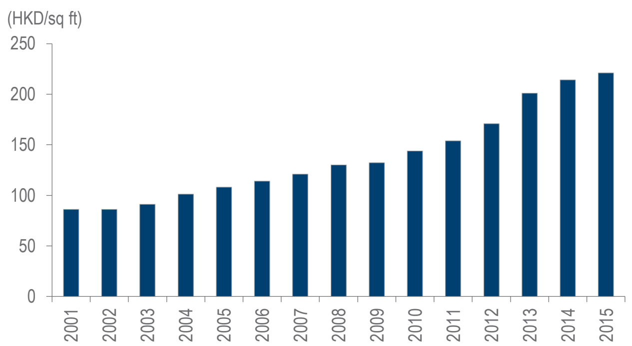
Source: Company

Hongkong Land: Central office portfolio occupancy rate



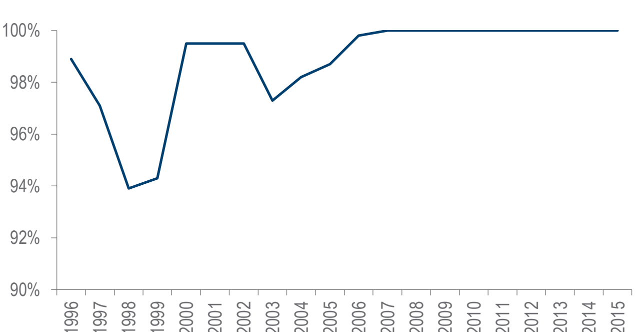
Source: Company

Hongkong Land: Central retail portfolio average rent



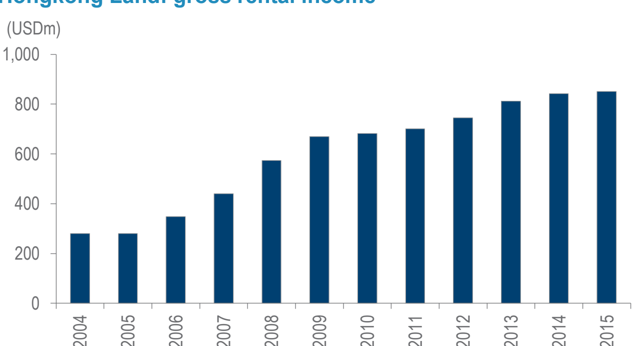
Source: Company

Hongkong Land: Central retail portfolio occupancy rate



Source: Company

Hongkong Land: gross rental income



Source: Company

Hongkong Land: Asia commercial property portfolio (end-2015)

(Attributable NFA)	Office ('000 sq ft)	Retail ('000 sq ft)	Hotel ('000 sq ft)	Total ('000 sq ft)
Hong Kong	4,140	588	143	4,871
Macau	0	93	151	244
Singapore	1,649	134	0	1,783
Jakarta	662	65	0	727
Hanoi	106	11	0	117
Bangkok	27	60	0	87
Others	71	0	312	383
Total attributable NFA	**6,655**	**951**	**606**	**8,212**

Source: Company

Hongkong Land: profile of its Central buildings

Building	Typical floor plate (NFA, sq ft)	No. of tenants
One Exchange Square	13,000	30-50
Two Exchange Square	13,000	50-120
Three Exchange Square	11,200	10-30
The Forum	7,000	1
Jardine House	14,500	50-120
Chater House	18,500	10-30
Alexandra House	11,500	50-120
Gloucester Tower	12,600	50-120
Edinburgh Tower	12,600	30-50
York House	8,200	10-30
Prince's Building	21,000	50-120

Source: Company, Daiwa

Hongkong Land: Central portfolio

			Net floor area (NFA)*				Gross floor area (GFA)**			
(m sq ft)		Stake	Office	Retail	Hotel	Total	Office	Retail	Hotel	Total
1	One Exchange Square	100%	0.57	-	-	0.57	0.67	-	-	0.67
2	Two Exchange Square	100%	0.51	-	-	0.51	0.60	-	-	0.60
3	Three Exchange Square	100%	0.32	-	-	0.32	0.38	-	-	0.38
4	The Forum	100%	0.04	-	-	0.04	0.05	-	-	0.05
	Podium (Exchange Square)	100%	-	0.05	-	0.05	-	0.09	-	0.09
5	Jardine House	100%	0.64	0.04	-	0.68	0.75	0.07	-	0.82
6	Chater House	100%	0.42	0.04	-	0.46	0.49	0.07	-	0.57
7	Alexander House	100%	0.32	0.05	-	0.38	0.38	0.09	-	0.47
8	Gloucester Tower	100%	0.47	-	-	0.47	0.56	-	-	0.56
9	Edinburgh Tower	100%	0.33	-	-	0.33	0.39	-	-	0.39
9a	The Landmark Mandarin Oriental	100%	-	-	0.14	0.14	-	-	0.17	0.17
10	York House	100%	0.11	-	-	0.11	0.13	-	-	0.13
11	Landmark Atrium	100%	-	0.26	-	0.26	-	0.52	-	0.52
12	Prince's Building	100%	0.41	0.14	-	0.55	0.48	0.23	-	0.71
			4.14	**0.59**	**0.14**	**4.87**	**4.87**	**1.07**	**0.17**	**6.11**

Source: Company, Daiwa

*Note: *NFA as disclosed in Hongkong Land's annual reports and corporate presentation materials*

***GFA as converted from its NFA by applying an 85% efficiency ratio to its offices & hotel and a 50-60% efficiency ratio to its retail properties*

Daiwa Capital Markets

Hysan Development (14 HK)

Target price: **HKD46.60** (from HKD46.60)

Share price (23 May): **HKD31.60** | Up/downside: **+47.4%**

Buy
(unchanged)

Paying more dividends, buying back shares

- Appears to consider share buybacks as part of its capital management
- Also making progress as an asset manager, in our view
- We think Hysan has the characteristics of a REIT. Reaffirm Buy (1)

Jonas Kan, CFA
(852) 2848 4439
jonas.kan@hk.daiwacm.com

What's new: Hysan raised its 2015 DPS by 7.3% YoY compared to a 5.7% YoY rise in its underlying net profit, meaning its payout ratio rose effectively by 1pp to 61.4%. Meanwhile, it spent HKD215m on buying back 6.75m shares in 2015, which we see as a step forward in its capital management and which should bode well for investor sentiment on the company.

What's the impact: First Hong Kong-family property firm to undertake systematic share buybacks. We see this as a breakthrough – Hysan being the first landlord to effectively declare that it sees share buybacks as a way to enhance shareholder returns. These buybacks appear to have become part of Hysan's capital management. In our view, the significance of such buybacks is that they allow Hysan to establish a mechanism whereby it can use its cash flow and balance sheet to safeguard the value of its equity when it needs to. Given that this could be perceived as a form of protection for minority investors, we think companies that embrace share buybacks deserve to trade at lower NAV discounts.

Progressing as an asset manager. Hysan has demonstrated that it has been able to improve what we consider its high-quality but undermanaged portfolio. We stick to our view that Causeway Bay South is an important component of a vibrant commercial hub and, hence, that Hysan constitutes a safe and credible vehicle in which to benefit from the hub's development.

Offices in Causeway Bay South and Lee Garden III look promising, as we think Causeway Bay is the first major sub-market to benefit from the positive spill-over effects from the Central office market (some IT and financial-services companies may even prefer a non-Central office location, in our view). This should bode well for the leasing prospects of Lee Garden III and help to balance concerns relating to Hong Kong's retail sector. In any case, we see Causeway Bay South as a niche retail segment that has been playing catch-up over the past few years, which should make it relatively more defensive vs. peers.

What we recommend: Accordingly, we reaffirm our Buy (1) rating and 12-month TP of HKD46.60, based on a 30% discount to our end-2016E NAV of HKD66.50. The key risk to our call: if Causeway Bay were to become less popular within Hong's Kong commercial property sector.

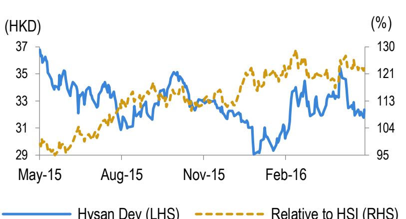
How we differ: We see Hysan as a REIT that is not subject to REIT rules, which could enable it to be traded more like a REIT than a traditional family-owned property company stock. This may not yet be fully recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	n.a.
Net profit change	-	-	n.a.
Core EPS (FD) change	0.7	0.7	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	29.05-36.30
Market cap (USDbn)	4.26
3m avg daily turnover (USDm)	4.79
Shares outstanding (m)	1,049
Major shareholder	Lee Hysan Estate Co Ltd (41.0%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	3,665	3,913	4,141
Operating profit (m)	3,053	3,269	3,483
Net profit (m)	2,530	2,721	2,896
Core EPS (fully-diluted)	2.412	2.594	2.761
EPS change (%)	11.6	7.5	6.4
Daiwa vs Cons. EPS (%)	8.3	17.6	22.8
PER (x)	13.1	12.2	11.4
Dividend yield (%)	4.5	4.9	5.2
DPS	1.430	1.540	1.650
PBR (x)	0.5	0.5	0.5
EV/EBITDA (x)	11.4	10.7	10.0
ROE (%)	3.7	3.9	4.1

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Completed investment properties (m sq ft)	3.7	4.4	4.4	4.1	4.1	4.1	4.1	4.1
Blended average office rent (on GFA) (HKD/sq ft)	34.6	35.7	39.1	46.2	50.6	53.8	57.7	57.1
Blended average retail rent (on GFA) (HKD/sq ft)	66.0	81.2	108.0	117.4	123.8	132.6	141.6	133.7
Blended average residential rent (on GFA) (HKD/sq ft)	32.3	37.6	34.7	37.6	37.4	39.5	40.5	41.6

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property rental - office	820	908	1,085	1,136	1,243	1,322	1,418	1,576
Property rental - retail	789	1,250	1,678	1,801	1,902	2,040	2,181	2,245
Other Revenue	313	328	300	287	285	303	314	320
Total Revenue	**1,922**	**2,486**	**3,063**	**3,224**	**3,430**	**3,665**	**3,913**	**4,141**
Other income	90	73	77	68	54	57	60	63
COGS	(262)	(423)	(405)	(404)	(414)	(428)	(450)	(467)
SG&A	(173)	(179)	(200)	(208)	(226)	(233)	(246)	(246)
Other op.expenses	(8)	(8)	(8)	(8)	(8)	(8)	(8)	(8)
Operating profit	**1,569**	**1,949**	**2,527**	**2,672**	**2,836**	**3,053**	**3,269**	**3,483**
Net-interest inc./(exp.)	(122)	(156)	(242)	(228)	(204)	(192)	(190)	(198)
Assoc/forex/extraord./others	170	211	237	240	246	270	273	279
Pre-tax profit	**1,617**	**2,004**	**2,522**	**2,684**	**2,878**	**3,131**	**3,352**	**3,564**
Tax	(226)	(288)	(372)	(386)	(438)	(442)	(467)	(499)
Min. int./pref. div./others	(81)	(94)	(107)	(135)	(157)	(159)	(164)	(169)
Net profit (reported)	**1,310**	**1,622**	**2,043**	**2,163**	**2,283**	**2,530**	**2,721**	**2,896**
Net profit (adjusted)	**1,310**	**1,622**	**2,043**	**2,163**	**2,283**	**2,530**	**2,721**	**2,896**
EPS (reported)(HKD)	**1.240**	**1.536**	**1.935**	**2.048**	**2.162**	**2.412**	**2.594**	**2.761**
EPS (adjusted)(HKD)	**1.240**	**1.536**	**1.935**	**2.048**	**2.162**	**2.412**	**2.594**	**2.761**
EPS (adjusted fully-diluted)(HKD)	**1.240**	**1.536**	**1.935**	**2.048**	**2.162**	**2.412**	**2.594**	**2.761**
DPS (HKD)	**0.800**	**0.950**	**1.170**	**1.230**	**1.320**	**1.430**	**1.540**	**1.650**
EBIT	**1,569**	**1,949**	**2,527**	**2,672**	**2,836**	**3,053**	**3,269**	**3,483**
EBITDA	**1,577**	**1,957**	**2,535**	**2,680**	**2,844**	**3,061**	**3,277**	**3,491**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	1,617	2,004	2,522	2,684	2,878	3,131	3,352	3,564
Depreciation and amortisation	8	8	8	8	8	8	8	8
Tax paid	(181)	(204)	(298)	(309)	(350)	(354)	(356)	(364)
Change in working capital	5	265	399	185	438	142	146	148
Other operational CF items	(82)	(63)	(3)	(20)	(50)	(86)	(91)	(89)
Cash flow from operations	**1,367**	**2,010**	**2,628**	**2,548**	**2,924**	**2,841**	**3,059**	**3,267**
Capex	(980)	(802)	(950)	(368)	(380)	(1,120)	(1,240)	(1,020)
Net (acquisitions)/disposals	(551)	0	0	0	0	0	0	0
Other investing CF items	0	0	0	0	0	0	0	0
Cash flow from investing	**(1,531)**	**(802)**	**(950)**	**(368)**	**(380)**	**(1,120)**	**(1,240)**	**(1,020)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	(215)	0	0	0
Dividends paid	(790)	(845)	(1,056)	(1,246)	(1,193)	(1,469)	(1,542)	(1,647)
Other financing CF items	(154)	(291)	(374)	(366)	(377)	(384)	(389)	(395)
Cash flow from financing	**(944)**	**(1,136)**	**(1,430)**	**(1,612)**	**(1,785)**	**(1,853)**	**(1,931)**	**(2,042)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(1,108)**	**72**	**248**	**568**	**758**	**(131)**	**(112)**	**205**
Free cash flow	387	1,208	1,678	2,180	2,544	1,721	1,819	2,247

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	2,961	2,311	4,123	3,634	2,804	2,754	2,641	2,844
Inventory	0	0	0	0	0	0	0	0
Accounts receivable	134	158	241	255	201	282	296	304
Other current assets	507	605	657	586	416	650	682	694
Total current assets	**3,602**	**3,074**	**5,021**	**4,475**	**3,421**	**3,686**	**3,619**	**3,842**
Fixed assets	530	580	604	710	705	714	722	735
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	55,236	64,769	70,469	73,838	74,662	75,738	77,222	78,386
Total assets	**59,368**	**68,423**	**76,094**	**79,023**	**78,788**	**80,138**	**81,563**	**82,963**
Short-term debt	1,507	699	1,055	1,589	250	230	210	180
Accounts payable	532	469	500	481	470	541	568	582
Other current liabilities	589	599	666	739	743	768	792	813
Total current liabilities	**2,628**	**1,767**	**2,221**	**2,809**	**1,463**	**1,539**	**1,570**	**1,575**
Long-term debt	5,156	5,242	6,449	4,858	4,609	4,710	4,730	4,758
Other non-current liabilities	840	967	1,243	1,227	1,348	1,332	1,401	1,426
Total liabilities	**8,624**	**7,976**	**9,913**	**8,894**	**7,420**	**7,581**	**7,701**	**7,759**
Share capital	5,299	5,315	5,318	7,640	7,642	7,642	7,642	7,642
Reserves/R.E./others	43,454	52,808	58,008	59,400	60,530	61,675	62,896	64,177
Shareholders' equity	**48,753**	**58,123**	**63,326**	**67,040**	**68,172**	**69,317**	**70,538**	**71,819**
Minority interests	1,991	2,324	2,855	3,089	3,196	3,240	3,325	3,386
Total equity & liabilities	**59,368**	**68,423**	**76,094**	**79,023**	**78,788**	**80,138**	**81,564**	**82,964**
EV	35,418	35,343	35,203	34,896	34,716	34,818	34,932	34,758
Net debt/(cash)	**3,702**	**3,630**	**3,381**	**2,813**	**2,055**	**2,186**	**2,299**	**2,094**
BVPS (HKD)	**46.168**	**55.041**	**59.968**	**63.485**	**64.557**	**66.079**	**67.243**	**68.464**

Key ratios (%)

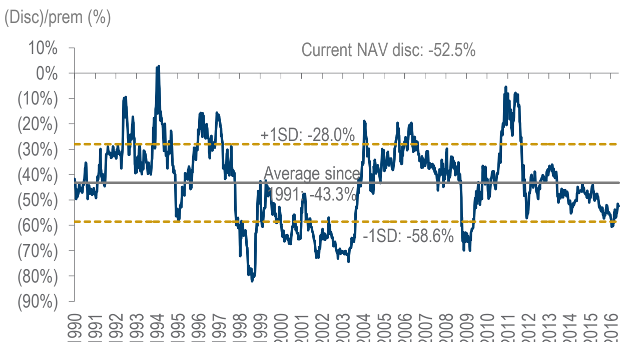
Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	9.0	29.3	23.2	5.3	6.4	6.9	6.8	5.8
EBITDA (YoY)	10.8	24.1	29.5	5.7	6.1	7.6	7.1	6.5
Operating profit (YoY)	10.9	24.2	29.7	5.7	6.1	7.7	7.1	6.5
Net profit (YoY)	14.1	23.9	26.0	5.9	5.6	10.8	7.5	6.4
Core EPS (fully-diluted) (YoY)	13.6	23.9	26.0	5.9	5.6	11.6	7.5	6.4
Gross-profit margin	86.4	83.0	86.8	87.5	87.9	88.3	88.5	88.7
EBITDA margin	82.0	78.7	82.8	83.1	82.9	83.5	83.7	84.3
Operating-profit margin	81.6	78.4	82.5	82.9	82.7	83.3	83.5	84.1
Net profit margin	68.1	65.2	66.7	67.1	66.6	69.0	69.5	69.9
ROAE	2.9	3.0	3.4	3.3	3.4	3.7	3.9	4.1
ROAA	2.4	2.5	2.8	2.8	2.9	3.2	3.4	3.5
ROCE	3.0	3.1	3.6	3.6	3.7	4.0	4.2	4.4
ROIC	2.7	2.8	3.2	3.2	3.3	3.5	3.7	3.9
Net debt to equity	7.6	6.2	5.3	4.2	3.0	3.2	3.3	2.9
Effective tax rate	14.0	14.4	14.8	14.4	15.2	14.1	13.9	14.0
Accounts receivable (days)	22.0	21.4	23.8	28.1	24.3	24.1	27.0	26.4
Current ratio (x)	1.4	1.7	2.3	1.6	2.3	2.4	2.3	2.4
Net interest cover (x)	12.9	12.5	10.4	11.7	13.9	15.9	17.2	17.6
Net dividend payout	64.5	61.8	60.5	60.1	61.1	59.3	59.4	59.8
Free cash flow yield	1.2	3.6	5.1	6.6	7.7	5.2	5.5	6.8

Source: FactSet, Daiwa forecasts

Company profile

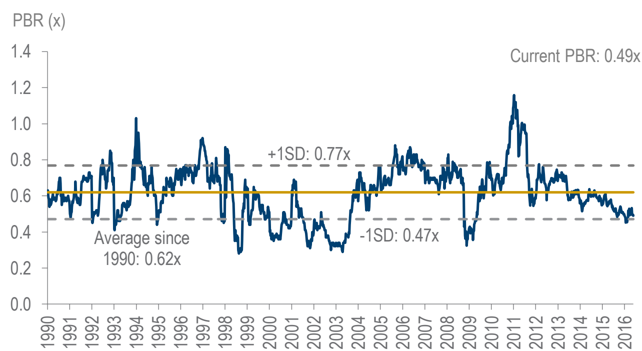
Hysan Development (Hysan) was founded by the Lee family in 1970 to redevelop the family's properties, and was listed on the Hong Kong Stock Exchange in 1981. Hysan currently owns an investment-property portfolio in Hong Kong amounting to 4.4m sq ft (4.2m sq ft on an attributable basis), of which 3.7m sq ft is in Causeway Bay. In addition, the group owns 0.69m sq ft of luxury residential properties in Hong Kong's Mid-Levels, and has a 24.7% stake in Grand Gateway 66, one of the largest and most prominent mixed commercial-property complexes in Shanghai.

Hysan: price/NAV



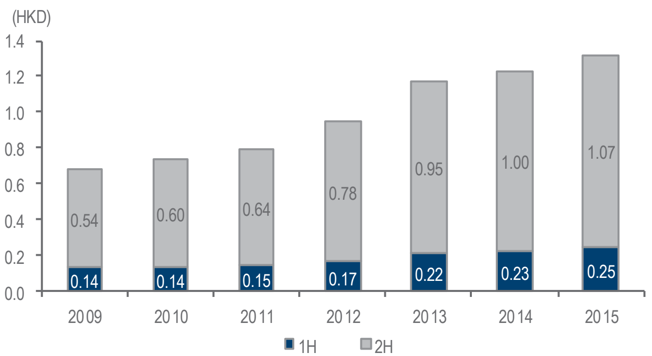
Source: Datastream, Daiwa forecasts

Hysan: PBR



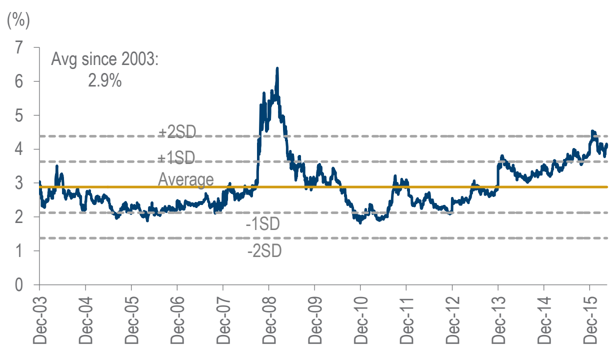
Source: Company, Datastream, Daiwa

Hysan: DPS



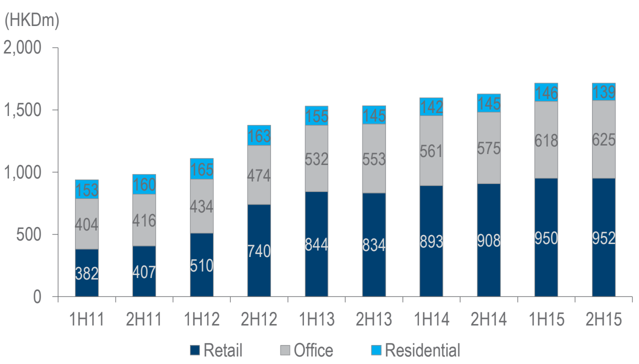
Source: Company

Hysan: dividend yield



Source: Company, Bloomberg, Daiwa

Hysan: half-yearly turnover by segment



Source: Company

Hysan: a new flagship store coming to Lee Garden One

Source: Daiwa

Hong Kong | Financials | 25 May 2016

Midland (1200 HK)

Target price: **HKD2.01** (from HKD3.15)

Share price (23 May): **HKD2.03** | Up/downside: **-0.9%**

Hold (unchanged)

Victim of government's house-buying measures

- Industry consolidation is happening but will likely take time
- Any government move to relax measures on house-buying is key
- Maintain Hold (3) rating, cutting TP to HKD2.01

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What's new: Hong Kong's weekend primary-market sales have picked up since late February, rising 210% WoW for the week ended 15 May 2016, which suggests to us that the primary market (which provides the largest amount of Midland's commission income) may have begun to stabilise.

What's the impact: A victim of government measures imposed in 2010, which have suppressed transaction volume. While such measures have helped primary-market sales, which reached all-time highs in Hong Kong in 2014 and 2015, the benefits have been undermined by competition that necessitated offering rebates to customers. Furthermore, historically, Hong Kong's property-agency industry has been focused on the secondary market and we think the industry has yet to fully adjust its cost structure to the "new normal" where the largest source of its commissions come from the primary market.

Industry consolidation happening. Our read is that many SME property agents are likely to downsize or close their businesses, which should enable major players like Midland to expand their market share over time. That said, we believe the process could take several years.

Relaxation of government measures is the key. Our read is that the government's measures have suppressed demand for flats and that such demand should remerge once these measures are relaxed. This should benefit property agents like Midland, which derives the bulk of its income from residential-property transactions. That said, whether the government will relax the rules is still uncertain. Our base case is that we assume no change in the rules in 2016, though we wouldn't be surprised if some initial steps were taken.

What we recommend: We maintain our Hold (3) rating on the stock, and lower our 12-month TP to HKD2.01 (from HKD3.15), based on a 1.2x PBR (previously 10x PER), representing a 50% discount to its average PBR of 2.4x since 2004; over 90% of its book value is cash on hand. We previously used a PER to derive our TP but this is no longer applicable as we expect Midland to still make net losses in 2016. Key upside risk: any relaxation in government measures; key downside risks: rising operating costs and dwindling market transaction volume.

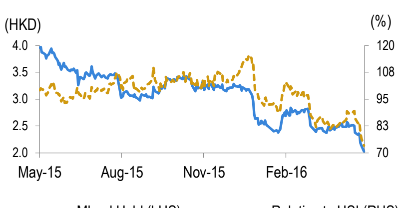
How we differ: Unlike some in the market, we believe that property agencies can still be viable businesses in Hong Kong, as long as they can adjust to the appropriate business model and cost structure.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	(14.4)	(11.6)	n.a.
Net profit change	n.a.	(40.6)	n.a.
Core EPS (FD) change	n.a.	(40.6)	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	2.03-3.92
Market cap (USDbn)	0.18
3m avg daily turnover (USDm)	0.10
Shares outstanding (m)	722
Major shareholder	Freddie Wong (27.9%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	3,499	3,766	4,104
Operating profit (m)	(136)	78	149
Net profit (m)	(119)	82	144
Core EPS (fully-diluted)	(0.165)	0.114	0.199
EPS change (%)	n.a.	n.a.	75.6
Daiwa vs Cons. EPS (%)	n.a.	609.5	47.7
PER (x)	n.a.	17.9	10.2
Dividend yield (%)	0.0	0.0	4.9
DPS	0.000	0.000	0.100
PBR (x)	1.2	1.1	1.1
EV/EBITDA (x)	n.a.	2.7	1.2
ROE (%)	n.a.	6.5	11.1

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Transaction volume - primary	10,854	12,961	9,986	16,825	16,799	10,500	11,500	12,300
Avg price per unit - primary (HKDm)	12.1	10.2	9.3	10.5	9.7	9.0	8.5	8.3
Transacted value - primary (HKDm)	130,990	132,200	92,479	176,951	162,221	94,500	97,750	102,090
Transaction volume - secondary	75,195	70,183	41,784	49,538	40,872	35,000	40,000	40,500
Avg price per unit - secondary (HKDm)	4.1	4.6	5.0	5.1	6.3	5.5	5.5	6.1
Transacted value - secondary (HKDm)	311,839	323,000	207,958	254,070	255,457	192,500	220,000	247,500

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Primary market commission	1,104	1,116	1,032	1,733	1,465	953	1,031	1,086
Secondary market commission	1,114	1,200	692	838	756	722	825	928
Other Revenue	1,180	1,595	1,573	1,545	1,687	1,824	1,910	2,090
Total Revenue	**3,398**	**3,911**	**3,297**	**4,116**	**3,908**	**3,499**	**3,766**	**4,104**
Other income	7	23	17	18	6	7	8	8
COGS	(1,126)	(1,305)	(986)	(1,437)	(1,290)	(1,085)	(1,168)	(1,264)
SG&A	(1,666)	(1,986)	(2,166)	(2,248)	(2,394)	(2,227)	(2,230)	(2,385)
Other op.expenses	(430)	(304)	(371)	(330)	(327)	(330)	(298)	(314)
Operating profit	**183**	**339**	**(209)**	**119**	**(97)**	**(136)**	**78**	**149**
Net-interest inc./(exp.)	4	12	2	(17)	(8)	3	4	5
Assoc/forex/extraord./others	25	7	8	12	14	12	13	15
Pre-tax profit	**212**	**358**	**(200)**	**114**	**(91)**	**(121)**	**95**	**169**
Tax	(53)	(60)	2	(39)	(9)	0	(15)	(28)
Min. int./pref. div./others	(25)	(48)	(6)	(11)	1	2	2	3
Net profit (reported)	**134**	**250**	**(204)**	**64**	**(99)**	**(119)**	**82**	**144**
Net profit (adjusted)	**134**	**250**	**(204)**	**64**	**(99)**	**(119)**	**82**	**144**
EPS (reported)(HKD)	**0.185**	**0.346**	**(0.282)**	**0.088**	**(0.137)**	**(0.165)**	**0.114**	**0.199**
EPS (adjusted)(HKD)	**0.185**	**0.346**	**(0.282)**	**0.088**	**(0.137)**	**(0.165)**	**0.114**	**0.199**
EPS (adjusted fully-diluted)(HKD)	**0.185**	**0.346**	**(0.282)**	**0.088**	**(0.137)**	**(0.165)**	**0.114**	**0.199**
DPS (HKD)	**0.307**	**0.200**	**0.000**	**0.000**	**0.000**	**0.000**	**0.000**	**0.100**
EBIT	**183**	**339**	**(209)**	**119**	**(97)**	**(136)**	**78**	**149**
EBITDA	**227**	**385**	**(151)**	**180**	**(54)**	**(91)**	**125**	**198**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	212	358	(200)	114	(91)	(121)	95	169
Depreciation and amortisation	44	46	58	61	43	45	47	49
Tax paid	(55)	(58)	(31)	(60)	(62)	(66)	(66)	(66)
Change in working capital	120	(34)	(103)	250	18	50	52	52
Other operational CF items	9	25	108	91	138	208	86	43
Cash flow from operations	**330**	**337**	**(168)**	**456**	**46**	**116**	**214**	**247**
Capex	(175)	(50)	(74)	(70)	(74)	(84)	(84)	(84)
Net (acquisitions)/disposals	(62)	(65)	24	0	0	0	0	0
Other investing CF items	(45)	(20)	18	(50)	(58)	(65)	(65)	(65)
Cash flow from investing	**(282)**	**(135)**	**(32)**	**(120)**	**(132)**	**(149)**	**(149)**	**(149)**
Change in debt	0	0	384	0	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(393)	(152)	(72)	0	0	0	0	0
Other financing CF items	(7)	(8)	4	(8)	(7)	(6)	(3)	(3)
Cash flow from financing	**(400)**	**(160)**	**316**	**(8)**	**(7)**	**(6)**	**(3)**	**(3)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(352)**	**42**	**116**	**328**	**(93)**	**(39)**	**62**	**95**
Free cash flow	155	287	(242)	386	(28)	32	130	163

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	1,249	1,290	1,434	1,764	1,303	1,226	1,291	1,389
Inventory	0	0	0	0	0	0	0	0
Accounts receivable	1,168	1,823	1,451	1,990	1,413	1,380	1,370	1,350
Other current assets	19	0	4	1	2	3	5	0
Total current assets	**2,436**	**3,113**	**2,889**	**3,755**	**2,718**	**2,609**	**2,666**	**2,739**
Fixed assets	242	281	276	241	272	292	307	322
Goodwill & intangibles	12	0	0	0	14	14	14	14
Other non-current assets	87	95	108	100	111	102	104	105
Total assets	**2,777**	**3,489**	**3,273**	**4,096**	**3,115**	**3,017**	**3,091**	**3,180**
Short-term debt	12	11	424	426	58	20	23	26
Accounts payable	1,121	1,659	1,311	2,041	1,515	1,568	1,554	1,635
Other current liabilities	0	22	8	20	6	7	8	10
Total current liabilities	**1,133**	**1,692**	**1,743**	**2,487**	**1,579**	**1,595**	**1,585**	**1,671**
Long-term debt	0	0	0	0	0	0	0	0
Other non-current liabilities	3	2	3	3	3	2	2	2
Total liabilities	**1,136**	**1,694**	**1,746**	**2,490**	**1,582**	**1,597**	**1,587**	**1,673**
Share capital	72	72	72	72	72	72	72	72
Reserves/R.E./others	1,433	1,539	1,266	1,334	1,259	1,140	1,222	1,224
Shareholders' equity	**1,505**	**1,611**	**1,338**	**1,406**	**1,331**	**1,212**	**1,294**	**1,296**
Minority interests	136	184	190	200	202	208	210	211
Total equity & liabilities	**2,777**	**3,489**	**3,273**	**4,096**	**3,115**	**3,017**	**3,091**	**3,180**
EV	307	317	590	265	352	396	334	239
Net debt/(cash)	**(1,237)**	**(1,279)**	**(1,010)**	**(1,338)**	**(1,245)**	**(1,206)**	**(1,268)**	**(1,363)**
BVPS (HKD)	**2.079**	**2.231**	**1.853**	**1.947**	**1.843**	**1.678**	**1.791**	**1.794**

Key ratios (%)

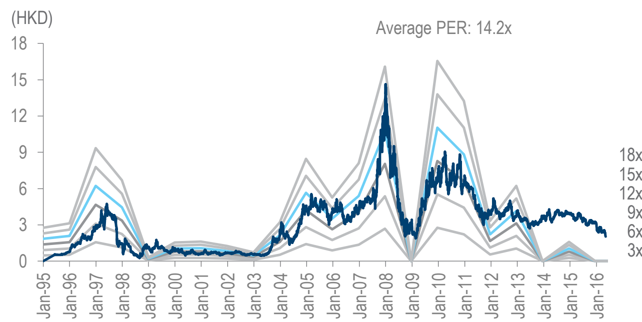
Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	(9.1)	15.1	(15.7)	24.8	(5.1)	(10.5)	7.6	9.0
EBITDA (YoY)	(69.5)	69.5	n.a.	n.a.	n.a.	n.a.	n.a.	58.4
Operating profit (YoY)	(72.2)	85.1	n.a.	n.a.	n.a.	n.a.	n.a.	91.0
Net profit (YoY)	(74.8)	86.3	n.a.	n.a.	n.a.	n.a.	n.a.	75.6
Core EPS (fully-diluted) (YoY)	(74.8)	86.8	n.a.	n.a.	n.a.	n.a.	n.a.	75.6
Gross-profit margin	66.9	66.6	70.1	65.1	67.0	69.0	69.0	69.2
EBITDA margin	6.7	9.8	n.a.	4.4	n.a.	n.a.	3.3	4.8
Operating-profit margin	5.4	8.7	n.a.	2.9	n.a.	n.a.	2.1	3.6
Net profit margin	3.9	6.4	(6.2)	1.5	(2.5)	(3.4)	2.2	3.5
ROAE	8.2	16.0	n.a.	4.6	n.a.	n.a.	6.5	11.1
ROAA	4.5	8.0	n.a.	1.7	n.a.	n.a.	2.7	4.6
ROCE	10.3	19.6	n.a.	6.0	n.a.	n.a.	5.3	9.7
ROIC	39.3	61.2	(40.4)	19.9	(34.9)	(54.2)	29.2	65.4
Net debt to equity	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Effective tax rate	25.0	16.8	n.a.	34.3	n.a.	n.a.	15.8	16.6
Accounts receivable (days)	130.3	139.6	181.2	152.6	158.9	145.7	133.3	121.0
Current ratio (x)	2.2	1.8	1.7	1.5	1.7	1.6	1.7	1.6
Net interest cover (x)	n.a.	n.a.	n.a.	7.0	n.a.	n.a.	n.a.	n.a.
Net dividend payout	165.7	57.9	n.a.	0.0	n.a.	n.a.	0.0	50.2
Free cash flow yield	10.6	19.6	n.a.	26.3	n.a.	2.2	8.9	11.1

Source: FactSet, Daiwa forecasts

Company profile

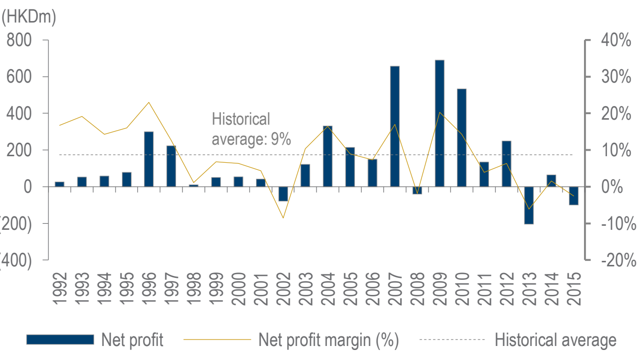
Midland Holdings is engaged principally in the provision of brokerage services for residential, industrial and commercial properties in Hong Kong and the Mainland. It is currently one of the two largest companies in the residential property-agency industry in Hong Kong, which is effectively a duopoly, with Midland and Centaline Property accounting for about a 66% share of the market.

Midland: PER bands



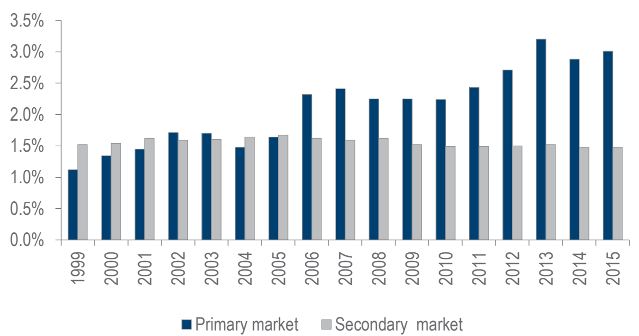
Source: Company, Bloomberg, Daiwa forecasts

Midland: net profit and net-profit margin



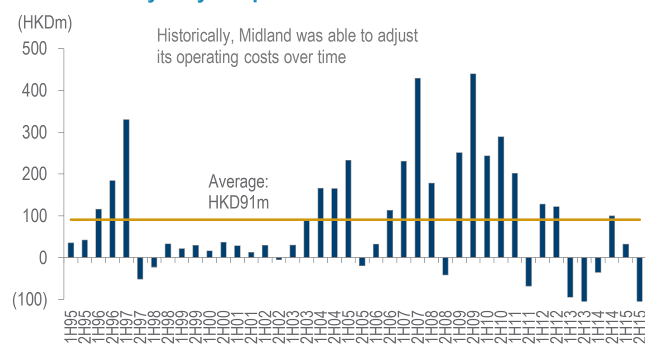
Source: Company, Daiwa

Midland: commission rate



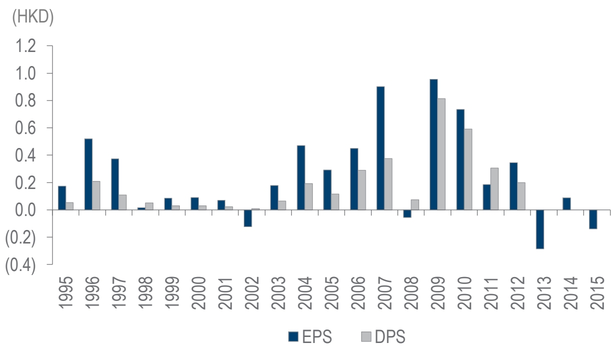
Source: Company

Midland: half-yearly net profit or loss since IPO



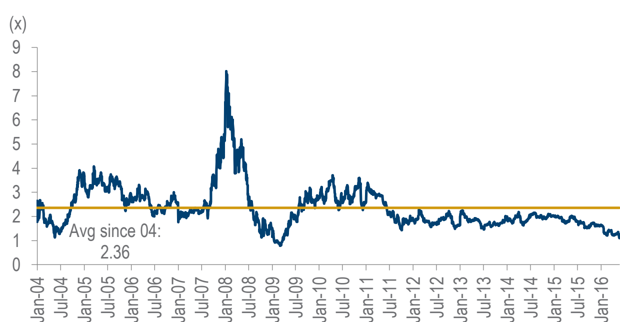
Source: Company, Daiwa

Midland: EPS and DPS



Source: Company

Midland: PBR



Source: Company, Datastream, Daiwa

MTR Corporation (66 HK)

Target price: **HKD42.70** (from HKD42.70)

Share price (23 May): **HKD35.85** | Up/downside: **+19.1%**

Outperform
(unchanged)

Can MTRC align the interests of all stakeholders?

- Has solved one overhang, but fare adjustment review still a challenge
- A lot will depend on how the fare adjustment issue is addressed
- Reiterating Outperform (2)

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What's new: The Legislative Council's approval in March of the budget to fund the Express Rail Link looks to remove the risk of cost over-runs for MTRC. Meanwhile, MTRC and the government will proceed with reviewing the Fare Adjustment Mechanism (FAM) before its scheduled expiry in 2017. The review presents both an opportunity and a threat to MTRC, in our view.

What's the impact: A lot will hinge on how the FAM issue is addressed. Given the current sociopolitical climate in Hong Kong, we expect there to be a number of controversial opinions expressed on the subject of the FAM. It is theoretically possible to separate MTRC's need to maximise shareholder returns and its responsibility to the public if the government (its largest shareholder) can make creative use of the dividends it stands to receive from MTRC in the next few years. That said, striking an arrangement that meets the expectations of all stakeholders will be challenging amid the current environment.

Faces a scheduling gap in property sales profit in 2016 but visibility for property sales profit should improve notably from 2017, given that MTRC has tendered out 6 projects since 2015 which are due to start contributing from 2018, while we estimate the profits from its Tiara project in Shenzhen should be recognised in 2017. Meanwhile, the group's new rental properties in Tsing Yi, Tai Wai and Lohas Park should start contributing from 2018 onward.

A stock to watch, though strong share-price performance since January 2015 likely to cap near-term upside. MTRC has been one of the best- performing blue chips since the beginning of 2015, having risen by 20% and outperformed the Hang Seng Index by 43bps since then. Against this backdrop, as well as the uncertainties related to the FAM review, we lowered our rating from Buy (1) to Outperform (2) "*Rating lowered on reduced upside potential" on 12 April.* That said, we believe a positive outcome for the FAM could remove a major overhang on MTRC shares and enhance visibility on its earnings and DPS prospects in 2016-18 and beyond.

What we recommend: We reaffirm our Outperform (2) rating and 12-month TP of HKD42.70, based on an unchanged 20% discount applied to our end-2016E SOTP valuation of HKD53.40. The key risk: an unfavourable revision to the FAM.

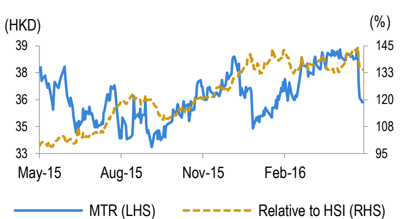
How we differ: We see MTRC as a potential global play among the Hong Kong blue chips, which could see it excel in terms of governance, dividend policy, defensiveness and product quality. We believe the market may not yet recognise the associated rerating potential.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	33.35-38.85
Market cap (USDbn)	26.75
3m avg daily turnover (USDm)	17.38
Shares outstanding (m)	5,797
Major shareholder	HKSAR Government (75.7%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	42,939	44,442	46,394
Operating profit (m)	11,211	11,930	13,108
Net profit (m)	8,740	10,280	12,258
Core EPS (fully-diluted)	1.508	1.773	2.115
EPS change (%)	(19.8)	17.6	19.2
Daiwa vs Cons. EPS (%)	(2.6)	4.0	28.5
PER (x)	23.8	20.2	17.0
Dividend yield (%)	9.2	9.5	3.5
DPS	3.300	3.400	1.250
PBR (x)	1.3	1.4	1.3
EV/EBITDA (x)	15.5	15.6	14.3
ROE (%)	5.3	6.6	8.0

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
No of passenger travelled (Mils)	1,367	1,553	1,600	1,676	1,707	1,763	1,831	1,826
Rental EBIT (HKDm)	2,819	3,027	3,547	3,945	4,267	4,360	4,611	4,824
Property sales profit (HKDm)	4,934	3,238	1,396	4,216	2,891	0	2,083	2,567

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Railway	26,383	28,417	30,341	32,828	31,788	32,471	33,289	35,236
Station Commercial	3,873	4,028	4,588	4,963	5,380	5,538	5,781	6,034
Other Revenue	3,167	3,294	3,778	2,365	4,533	4,930	5,372	5,124
Total Revenue	**33,423**	**35,739**	**38,707**	**40,156**	**41,701**	**42,939**	**44,442**	**46,394**
Other income	0	0	0	0	0	0	0	0
COGS	(17,621)	(17,929)	(19,224)	(19,525)	(20,125)	(20,324)	(20,789)	(21,248)
SG&A	(3,896)	(4,279)	(4,618)	(4,849)	(5,224)	(5,346)	(5,430)	(5,520)
Other op.expenses	(3,635)	(4,539)	(5,085)	(5,316)	(5,730)	(6,059)	(6,293)	(6,518)
Operating profit	**8,271**	**8,992**	**9,780**	**10,466**	**10,622**	**11,211**	**11,930**	**13,108**
Net-interest inc./(exp.)	(921)	(879)	(732)	(545)	(599)	(938)	(1,330)	(1,171)
Assoc/forex/extraord./others	5,231	3,694	1,554	4,337	3,252	475	2,684	3,205
Pre-tax profit	**12,581**	**11,807**	**10,602**	**14,258**	**13,275**	**10,748**	**13,284**	**15,142**
Tax	(2,113)	(1,893)	(1,819)	(2,496)	(2,237)	(1,809)	(2,779)	(2,650)
Min. int./pref. div./others	0	(139)	(183)	(191)	(144)	(199)	(225)	(234)
Net profit (reported)	**10,468**	**9,775**	**8,600**	**11,571**	**10,894**	**8,740**	**10,280**	**12,258**
Net profit (adjusted)	**10,468**	**9,775**	**8,600**	**11,571**	**10,894**	**8,740**	**10,280**	**12,258**
EPS (reported)(HKD)	**1.832**	**1.711**	**1.505**	**1.996**	**1.879**	**1.508**	**1.773**	**2.115**
EPS (adjusted)(HKD)	**1.832**	**1.711**	**1.505**	**1.996**	**1.879**	**1.508**	**1.773**	**2.115**
EPS (adjusted fully-diluted)(HKD)	**1.832**	**1.711**	**1.505**	**1.996**	**1.879**	**1.508**	**1.773**	**2.115**
DPS (HKD)	**0.760**	**0.790**	**0.920**	**1.050**	**1.060**	**3.300**	**3.400**	**1.250**
EBIT	**8,271**	**8,992**	**9,780**	**10,466**	**10,622**	**11,211**	**11,930**	**13,108**
EBITDA	**11,477**	**12,200**	**13,152**	**13,951**	**14,471**	**15,175**	**16,053**	**17,396**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	12,581	11,807	10,602	14,258	13,275	10,748	13,284	15,142
Depreciation and amortisation	3,250	3,208	3,372	3,485	3,849	3,964	4,123	4,288
Tax paid	(1,600)	(1,799)	(1,343)	(1,872)	(1,678)	(1,357)	(2,084)	(1,988)
Change in working capital	680	654	895	950	2,935	2,958	3,020	3,860
Other operational CF items	5,216	6,737	5,200	9,600	2,558	463	2,789	2,593
Cash flow from operations	**20,127**	**20,607**	**18,726**	**26,421**	**20,939**	**16,776**	**21,132**	**23,896**
Capex	(18,462)	(11,125)	(13,356)	(13,513)	(20,084)	(14,560)	(14,690)	(13,690)
Net (acquisitions)/disposals	353	367	341	390	400	400	400	400
Other investing CF items	243	253	258	265	280	280	280	280
Cash flow from investing	**(17,866)**	**(10,505)**	**(12,757)**	**(12,858)**	**(19,404)**	**(13,880)**	**(14,010)**	**(13,010)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	19	20	0	0	0	0	0	0
Dividends paid	(2,148)	(4,519)	(4,772)	(5,097)	(5,505)	(18,825)	(19,301)	(6,950)
Other financing CF items	(3,104)	(3,450)	(3,496)	(2,866)	(2,910)	(2,930)	(2,935)	(2,935)
Cash flow from financing	**(5,233)**	**(7,949)**	**(8,268)**	**(7,963)**	**(8,415)**	**(21,755)**	**(22,236)**	**(9,885)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(2,972)**	**2,153**	**(2,299)**	**5,600**	**(6,880)**	**(18,859)**	**(15,114)**	**1,001**
Free cash flow	1,665	9,482	5,370	12,908	855	2,216	6,442	10,206

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	16,100	18,664	17,297	18,893	12,318	5,459	5,980	6,250
Inventory	3,757	3,016	1,105	1,076	1,139	898	765	712
Accounts receivable	3,964	4,474	3,621	3,797	5,135	5,320	5,545	5,780
Other current assets	6,613	6,723	1,935	2,438	2,053	2,312	2,465	2,540
Total current assets	**30,434**	**32,877**	**23,958**	**26,204**	**20,645**	**13,989**	**14,755**	**15,282**
Fixed assets	152,068	155,894	163,156	171,202	175,719	183,691	188,221	192,786
Goodwill & intangibles	344	256	115	105	81	90	92	95
Other non-current assets	15,027	17,888	28,594	30,187	44,658	46,123	48,120	49,156
Total assets	**197,873**	**206,915**	**215,823**	**227,698**	**241,103**	**243,893**	**251,188**	**257,319**
Short-term debt	0	355	47	546	1,649	0	0	0
Accounts payable	16,402	15,119	13,793	16,421	22,860	23,125	23,658	23,986
Other current liabilities	2,721	2,415	2,723	3,697	3,820	3,945	4,025	4,325
Total current liabilities	**19,123**	**17,889**	**16,563**	**20,664**	**28,329**	**27,070**	**27,683**	**28,311**
Long-term debt	23,168	23,222	24,464	19,961	19,162	32,812	48,447	47,716
Other non-current liabilities	26,537	21,324	22,094	23,591	23,441	24,177	24,250	24,650
Total liabilities	**68,828**	**62,435**	**63,121**	**64,216**	**70,932**	**84,059**	**100,380**	**100,677**
Share capital	44,062	44,281	44,442	45,280	46,317	46,317	46,317	46,317
Reserves/R.E./others	84,797	99,992	108,115	118,045	123,738	113,395	104,360	110,183
Shareholders' equity	**128,859**	**144,273**	**152,557**	**163,325**	**170,055**	**159,712**	**150,677**	**156,500**
Minority interests	186	207	145	157	116	122	131	142
Total equity & liabilities	**197,873**	**206,915**	**215,823**	**227,698**	**241,103**	**243,893**	**251,188**	**257,319**
EV	215,076	212,942	215,181	209,593	216,431	235,298	250,420	249,430
Net debt/(cash)	**7,068**	**4,913**	**7,214**	**1,614**	**8,493**	**27,353**	**42,467**	**41,466**
BVPS (HKD)	**22.555**	**25.253**	**26.703**	**28.174**	**29.335**	**27.551**	**25.992**	**26.997**

Key ratios (%)

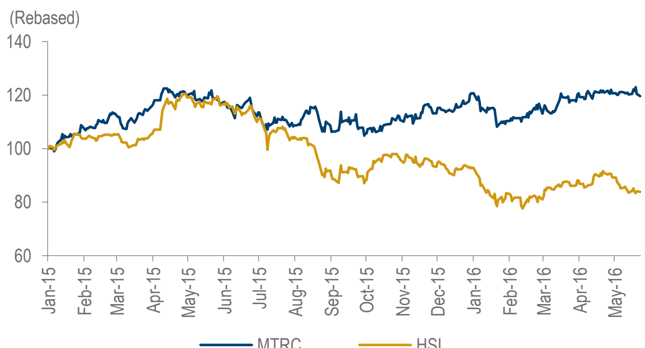
Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	13.2	6.9	8.3	3.7	3.8	3.0	3.5	4.4
EBITDA (YoY)	5.1	6.3	7.8	6.1	3.7	4.9	5.8	8.4
Operating profit (YoY)	6.1	8.7	8.8	7.0	1.5	5.5	6.4	9.9
Net profit (YoY)	20.9	(6.6)	(12.0)	34.5	(5.9)	(19.8)	17.6	19.2
Core EPS (fully-diluted) (YoY)	20.9	(6.6)	(12.0)	32.6	(5.9)	(19.8)	17.6	19.2
Gross-profit margin	47.3	49.8	50.3	51.4	51.7	52.7	53.2	54.2
EBITDA margin	34.3	34.1	34.0	34.7	34.7	35.3	36.1	37.5
Operating-profit margin	24.7	25.2	25.3	26.1	25.5	26.1	26.8	28.3
Net profit margin	31.3	27.4	22.2	28.8	26.1	20.4	23.1	26.4
ROAE	8.5	7.2	5.8	7.3	6.5	5.3	6.6	8.0
ROAA	5.5	4.8	4.1	5.2	4.6	3.6	4.2	4.8
ROCE	5.7	5.6	5.7	5.8	5.7	5.8	6.1	6.5
ROIC	5.3	5.3	5.2	5.3	5.1	5.1	5.0	5.5
Net debt to equity	5.5	3.4	4.7	1.0	5.0	17.1	28.2	26.5
Effective tax rate	16.8	16.0	17.2	17.5	16.9	16.8	20.9	17.5
Accounts receivable (days)	38.3	43.1	38.2	33.7	39.1	44.4	44.6	44.5
Current ratio (x)	1.6	1.8	1.4	1.3	0.7	0.5	0.5	0.5
Net interest cover (x)	9.0	10.2	13.4	19.2	17.7	12.0	9.0	11.2
Net dividend payout	41.5	46.2	61.1	52.6	56.4	218.9	191.7	59.1
Free cash flow yield	0.8	4.6	2.6	6.2	0.4	1.1	3.1	4.9

Source: FactSet, Daiwa forecasts

Company profile

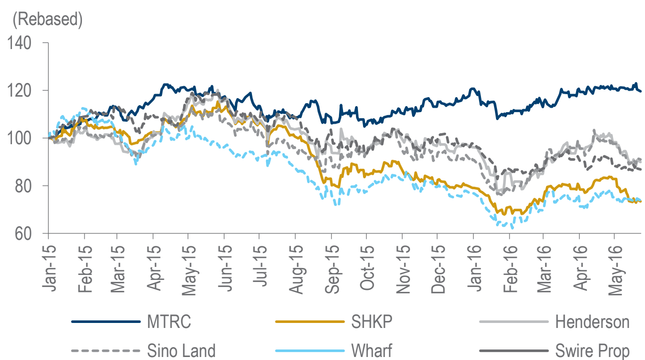
MTRC is the only rail company in Hong Kong. In December 2007, it merged with the KCRC and now operates a rail network that encompasses the whole of Hong Kong. The company's traditional business model is characterised as "rail and property", which allows it to award property development rights to developers to raise funds to finance the construction of new subway lines.

MTRC: share price performance vs. HSI (since Jan 2015)



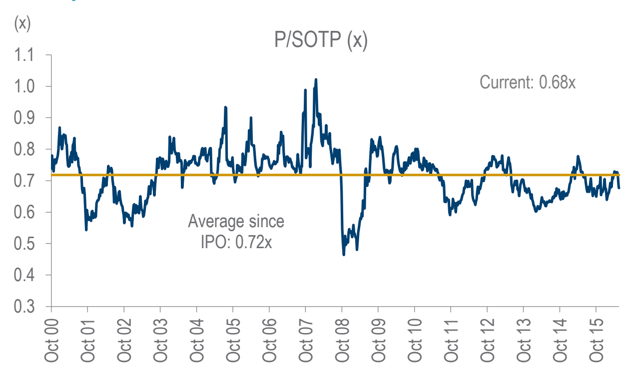
Source: Bloomberg, Daiwa

MTRC: share price performance vs. major property companies



Source: Bloomberg, Daiwa

MTRC: price/SOTP valuation



Source: Datastream, Daiwa estimates

MTRC: government's share of annual dividend

Year	Dividend declared by MTRC* (HKDm)	Dividend received HKSAR Government* (HKDm)
2001	2,118	1,621
2002	2,161	1,645
2003	2,215	1,690
2004	2,259	1,727
2005	2,299	1,760
2006	2,328	1,783
2007	2,522	1,934
2008	2,715	2,084
2009	2,977	2,287
2010	3,405	2,616
2011	4,396	3,370
2012	4,575	3,502
2013	5,335	4,080
2014	6,116	4,655
2015	6,210	4,701
Total	**51,630**	**39,454**

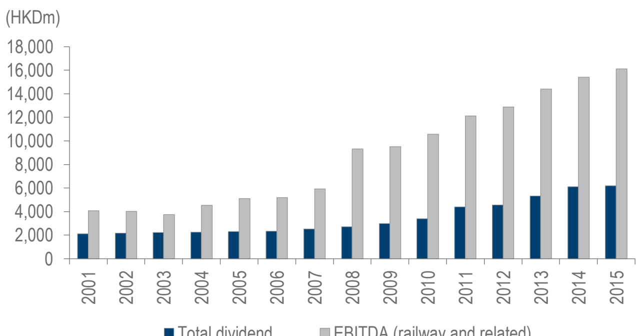
Source: Company, Daiwa
Note: * Note: the government and some other shareholders have opted to receive shares in lieu of cash dividends in the past

Different scenarios on the relationship between MTRC, the government, investors, and the Hong Kong public

	Worst case	Base case	Best case
Investor perception of MTRC	- Obliged to yield to social and political pressure and cannot safeguard the interests of minority shareholders and investors	- Owns some valuable franchises and property assets. However, there are uncertainties as to whether it can utilise them in the best interests of all its shareholders and investors	- MTRC is able to strike a fair and proper balance between its various stakeholders and the company and the government will strive to safeguard the interests of all minority shareholders and investors
MTRC as a public listed company	- Cannot work in the best commercial interests of its minority shareholders and investors	- There is always uncertainty as to whether it can safeguard the commercial interests of the minority shareholders and investors	- MTRC develops a fair and equitable way to deal with potential conflicts associated with its roles
MTRC as the provider of a key transport service for the community	- This has adversely affected MTRC's ability to work for the best interests of minority shareholders and investors	- The risk exists that MTRC may lean more toward yielding to social and political pressure rather than maximising the interests of its minority shareholders and investors	- MTRC, the government and the public develop a fair, open, objective and equitable mechanism to determine the appropriate fare levels and service standard for rail services in Hong Kong. If the government can use the dividends it receives from MTRC to help manage the social dimension of MTRC's business, this could result in a positive alignment of the interests of all of MTRC's stakeholders and a separation of MTRC's financial duties to deliver returns to investors from its social responsibilities
MTRC as an entity majority owned by the SAR Govt.	- The political dimension associated with this will always mean that MTRC may have to bear some responsibility for what it may not have to bear were it not majority owned by the government	- Lingering risk that MTRC may have to compromise its ability to work in the best interests of all its shareholders	- The government, society and MTRC develop a transparent and equitable way to address the potential conflicts associated with MTRC's different roles, and MTRC becomes an exemplary case in Hong Kong from a governance perspective. MTRC's special position also allows it to access opportunities not normally accessible by purely commercial organisations
MTRC's strong cash flow	- Obliged to use its cash flow to help address the political problems faced by its major shareholder rather than deploy it to maximise the interests of all its shareholders and investors	- Uncertainties exist as to whether MTRC can use its cash flow in the best interests of its minority shareholders and investors	- MTRC uses its strong cash flow to provide strong and growing dividends to all its shareholders, and the government can make creative use of the strong dividends it has received from MTRC to address the social and political issues that MTRC may be facing
The cost over-run issue of the Express Rail Link	- MTRC and the government go to court to settle the issue through legal means	- It develops into a severe social and political crisis, though eventually the government does get approval from Legco for the extra funding given fears of the severe consequences that may result from a forced suspension of the project	- MTRC pays higher dividends to all shareholders and the dividends the government receives from the MTRC become one way of addressing the issues caused by the delay and cost over-run of the project

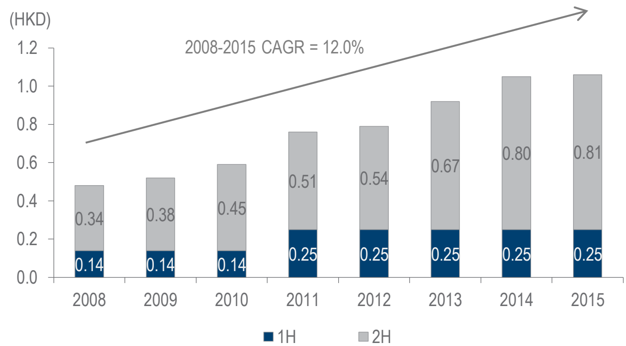
Source: Daiwa

MTRC: total dividend, railway and related EBITDA



Source: Company, Daiwa

MTRC: DPS history

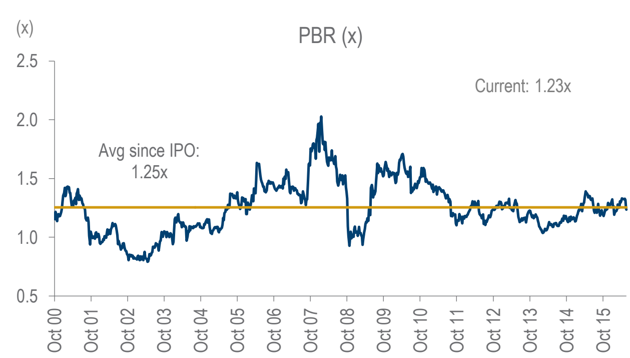


Source: Company, Daiwa

MTRC: contribution from overseas and China projects

Source: Company, Daiwa

MTRC: PBR



Source: Company, Datastream, Daiwa

Daiwa
Capital Markets

Daiwa
Capital Markets

Daiwa Capital Markets

SHK Properties (16 HK)

Target price: **HKD131.60** (from HKD131.60)

Share price (23 May): **HKD86.95** | Up/downside: **+51.3%**

5 4 3 2 1

Buy
(unchanged)

Impressive rental income stream and more

- Over 3-fold rise in gross rental income since FY05…
- …Paving the way to expand the scale of its property sales business
- Looks undervalued even just relative to its rental income; reaffirm Buy

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What's new: SHK Properties' (SHKP) 2 projects (the Utlima II and Ocean Wings) have sold well in recent weeks (bringing in sales proceeds of over HKD13bn in 7 weeks, we estimate) amid a challenging market. We see this performance as testament to the quality of SHKP's residential landbank and its brand value in Hong Kong, which bodes well for the company's earnings and NAV growth for FY16-18E.

What's the impact: Over 3-fold rise in gross rental income not reflected in share price. In our view, SHKP's strategic focus to significantly expand its rental portfolio since the 1990s has started paying off, as reflected in a 3-fold-plus surge in its annual gross rental since FY05 to some HKD20bn in FY16E, on our estimates (see page 2). However, SHKP's share price as at 23 May is just 7% below its end-2015 level of HKD93.60 and a full 50% below its 2008 peak of HKD172.80.

Another major harvest in the making? In our view, SHKP has sharpened its focus on its residential-property sales businesses since 2011, which has resulted in a significant rise in its residential landbank in Hong Kong (including many prime sites in urban areas and the New Territories). Much depends on execution, but we believe the company is on track to see a major harvesting period for its residential-property sales businesses.

Dividend policy and capital management key to unlocking value. Based on its 28.8m sq ft of completed rental properties as at end-2015, the implied cap rate of its rental properties is 8.3%, which could hardly be obtained in the physical market. Or, put another way, SHKP's current stock valuation implies that its entire Hong Kong landbank is trading at a blended average price of HKD4,822/sq ft. We continue to believe there is significant investment value to be unlocked in the shares of SHKP. Higher dividend payouts and share buybacks are potential share-price catalysts, in our view.

What we recommend: We affirm our Buy (1) rating and 12-month target price of HKD131.60, based on a 30% discount applied to our end-2016E NAV of HKD188.0/share. The key risk is a larger-than-expected deterioration in the economies of Hong Kong and China.

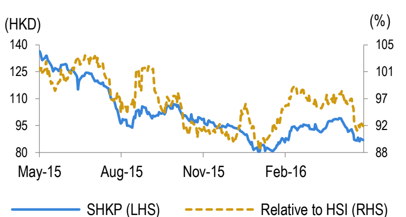
How we differ: We believe that the equity valuation of SHKP has yet to reflect the surge in its gross rental since 2005 and the possibility that its property sales business could be entering a harvesting period.

Forecast revisions (%)

Year to 30 Jun	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	80.35-136.40
Market cap (USDbn)	32.40
3m avg daily turnover (USDm)	50.91
Shares outstanding (m)	2,895
Major shareholder	Kwok family (47.0%)

Financial summary (HKD)

Year to 30 Jun	16E	17E	18E
Revenue (m)	89,765	98,658	102,420
Operating profit (m)	33,850	39,623	41,327
Net profit (m)	25,810	30,620	32,180
Core EPS (fully-diluted)	8.915	10.577	11.116
EPS change (%)	26.1	18.6	5.1
Daiwa vs Cons. EPS (%)	8.0	32.7	24.5
PER (x)	9.8	8.2	7.8
Dividend yield (%)	4.3	4.6	4.8
DPS	3.700	4.000	4.200
PBR (x)	0.5	0.5	0.5
EV/EBITDA (x)	6.9	5.9	5.6
ROE (%)	5.6	6.3	6.4

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Financial summary

Key assumptions

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Rental EBIT (HKDm)	9,511	11,069	12,236	14,272	15,352	16,600	17,795	19,130
Property sales profit (HKDm)	16,647	13,074	7,190	10,511	7,332	11,240	15,580	15,890
Size of completed investment properties in HK (m sq ft)	27.7	28.3	28.6	28.7	28.8	29.4	29.4	29.4
Size of completed investment properties in China (m sq ft)	7.5	9.4	9.5	9.5	11.6	14.3	15.2	16.1

Profit and loss (HKDm)

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales	36,230	37,032	20,060	36,330	21,704	39,250	44,860	48,560
Rental income	12,609	14,444	16,019	18,489	19,681	21,009	23,050	24,560
Other Revenue	13,714	24,585	17,714	20,281	25,398	29,506	30,748	29,300
Total Revenue	**62,553**	**76,061**	**53,793**	**75,100**	**66,783**	**89,765**	**98,658**	**102,420**
Other income	574	532	985	1,009	594	1,080	1,120	1,165
COGS	(31,367)	(43,894)	(27,013)	(43,565)	(36,597)	(53,409)	(56,458)	(58,456)
SG&A	(1,284)	(1,361)	(1,132)	(1,200)	(1,272)	(1,348)	(1,390)	(1,420)
Other op.expenses	(1,657)	(1,718)	(2,036)	(2,150)	(2,198)	(2,238)	(2,307)	(2,382)
Operating profit	**28,819**	**29,620**	**24,597**	**29,194**	**27,310**	**33,850**	**39,623**	**41,327**
Net-interest inc./(exp.)	(1,199)	(1,532)	(2,176)	(2,339)	(2,180)	(2,420)	(2,380)	(2,350)
Assoc/forex/extraord./others	0	0	0	0	0	0	0	0
Pre-tax profit	**27,620**	**28,088**	**22,421**	**26,855**	**25,130**	**31,430**	**37,243**	**38,977**
Tax	(5,831)	(5,896)	(3,454)	(4,773)	(4,880)	(5,185)	(6,143)	(6,305)
Min. int./pref. div./others	(310)	(514)	(348)	(667)	(425)	(435)	(480)	(492)
Net profit (reported)	**21,479**	**21,678**	**18,619**	**21,415**	**19,825**	**25,810**	**30,620**	**32,180**
Net profit (adjusted)	**21,479**	**21,678**	**18,619**	**21,415**	**19,825**	**25,810**	**30,620**	**32,180**
EPS (reported)(HKD)	**8.358**	**8.435**	**7.245**	**8.018**	**7.070**	**8.915**	**10.577**	**11.116**
EPS (adjusted)(HKD)	**8.358**	**8.435**	**7.245**	**8.018**	**7.070**	**8.915**	**10.577**	**11.116**
EPS (adjusted fully-diluted)(HKD)	**8.358**	**8.435**	**7.245**	**8.018**	**7.070**	**8.915**	**10.577**	**11.116**
DPS (HKD)	**3.350**	**3.350**	**3.350**	**3.350**	**3.350**	**3.700**	**4.000**	**4.200**
EBIT	**28,819**	**29,620**	**24,597**	**29,194**	**27,310**	**33,850**	**39,623**	**41,327**
EBITDA	**30,189**	**31,041**	**26,321**	**31,024**	**29,178**	**35,753**	**41,578**	**43,348**

Cash flow (HKDm)

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	27,620	28,088	22,421	26,855	25,130	31,430	37,243	38,977
Depreciation and amortisation	1,370	1,421	1,724	1,830	1,868	1,903	1,955	2,021
Tax paid	(3,498)	(2,606)	(3,496)	(4,020)	(4,160)	(4,430)	(4,790)	(4,920)
Change in working capital	(2,797)	3,406	1,655	1,320	7,510	1,560	1,680	1,756
Other operational CF items	1,589	1,889	2,392	2,679	2,620	2,960	3,008	3,110
Cash flow from operations	**24,284**	**32,198**	**24,696**	**28,664**	**32,968**	**33,423**	**39,096**	**40,944**
Capex	(30,949)	(26,206)	(9,673)	(33,630)	(16,431)	(28,745)	(23,250)	(25,680)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	(414)	(425)	(430)	(450)	(460)	(470)	(490)	(512)
Cash flow from investing	**(31,363)**	**(26,631)**	**(10,103)**	**(34,080)**	**(16,891)**	**(29,215)**	**(23,740)**	**(26,192)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	11,185	10,000	0	0
Dividends paid	(6,935)	(8,610)	(3,353)	(8,948)	(9,850)	(10,860)	(11,925)	(12,125)
Other financing CF items	(1,339)	(1,349)	(2,471)	(2,680)	(2,780)	(2,565)	(2,370)	(2,370)
Cash flow from financing	**(8,274)**	**(9,959)**	**(5,824)**	**(11,628)**	**(1,445)**	**(3,425)**	**(14,295)**	**(14,495)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(15,353)**	**(4,391)**	**8,769**	**(17,044)**	**14,632**	**783**	**1,061**	**257**
Free cash flow	(6,665)	5,992	15,023	(4,966)	16,537	4,678	15,846	15,264

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	7,898	14,338	16,471	18,528	32,561	32,507	34,785	35,680
Inventory	9,935	10,452	10,825	1,046	294	2,350	2,650	2,720
Accounts receivable	23,932	24,159	18,191	23,394	21,584	25,380	26,540	26,850
Other current assets	90,052	107,840	123,125	149,409	149,750	154,124	165,278	168,250
Total current assets	**131,817**	**156,789**	**168,612**	**192,377**	**204,189**	**214,361**	**229,253**	**233,500**
Fixed assets	235,653	257,324	286,564	307,112	334,826	343,932	346,833	360,217
Goodwill & intangibles	47	48	51	53	55	58	58	59
Other non-current assets	45,680	53,409	57,669	57,506	65,040	63,650	65,700	66,960
Total assets	**413,197**	**467,570**	**512,896**	**557,048**	**604,110**	**622,001**	**641,844**	**660,736**
Short-term debt	9,682	9,801	8,060	9,241	10,816	10,210	10,120	10,030
Accounts payable	20,452	22,256	22,753	25,283	25,690	27,320	27,960	28,125
Other current liabilities	8,666	9,870	20,504	12,031	21,227	13,650	13,980	14,120
Total current liabilities	**38,800**	**41,927**	**51,317**	**46,555**	**57,733**	**51,180**	**52,060**	**52,275**
Long-term debt	50,753	61,465	56,570	74,490	72,316	72,085	73,392	74,120
Other non-current liabilities	11,449	13,219	14,480	16,314	17,243	17,720	18,450	18,560
Total liabilities	**101,002**	**116,611**	**122,367**	**137,359**	**147,292**	**140,985**	**143,902**	**144,955**
Share capital	1,285	1,308	1,335	1,335	1,335	1,446	1,446	1,446
Reserves/R.E./others	305,680	345,251	384,577	413,448	449,691	473,675	490,516	508,215
Shareholders' equity	**306,965**	**346,559**	**385,912**	**414,783**	**451,026**	**475,121**	**491,962**	**509,661**
Minority interests	5,230	4,400	4,617	4,906	5,792	5,895	5,980	6,120
Total equity & liabilities	**413,197**	**467,570**	**512,896**	**557,048**	**604,110**	**622,001**	**641,844**	**660,736**
EV	267,552	263,533	250,962	268,240	251,108	248,053	245,077	243,750
Net debt/(cash)	**52,537**	**56,928**	**48,159**	**65,203**	**50,571**	**49,788**	**48,727**	**48,470**
BVPS (HKD)	**119.442**	**134.848**	**150.160**	**155.291**	**160.851**	**164.118**	**169.935**	**176.049**

Key ratios (%)

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	88.4	21.6	(29.3)	39.6	(11.1)	34.4	9.9	3.8
EBITDA (YoY)	64.4	2.8	(15.2)	17.9	(6.0)	22.5	16.3	4.3
Operating profit (YoY)	69.1	2.8	(17.0)	18.7	(6.5)	23.9	17.1	4.3
Net profit (YoY)	54.7	0.9	(14.1)	15.0	(7.4)	30.2	18.6	5.1
Core EPS (fully-diluted) (YoY)	54.4	0.9	(14.1)	10.7	(11.8)	26.1	18.6	5.1
Gross-profit margin	49.9	42.3	49.8	42.0	45.2	40.5	42.8	42.9
EBITDA margin	48.3	40.8	48.9	41.3	43.7	39.8	42.1	42.3
Operating-profit margin	46.1	38.9	45.7	38.9	40.9	37.7	40.2	40.4
Net profit margin	34.3	28.5	34.6	28.5	29.7	28.8	31.0	31.4
ROAE	7.8	6.6	5.1	5.3	4.6	5.6	6.3	6.4
ROAA	5.6	4.9	3.8	4.0	3.4	4.2	4.8	4.9
ROCE	8.6	7.5	5.6	6.1	5.2	6.1	6.9	7.0
ROIC	7.0	6.1	4.9	5.2	4.4	5.4	6.1	6.2
Net debt to equity	17.1	16.4	12.5	15.7	11.2	10.5	9.9	9.5
Effective tax rate	21.1	21.0	15.4	17.8	19.4	16.5	16.5	16.2
Accounts receivable (days)	116.7	115.4	143.7	101.1	122.9	95.5	96.0	95.1
Current ratio (x)	3.4	3.7	3.3	4.1	3.5	4.2	4.4	4.5
Net interest cover (x)	24.0	19.3	11.3	12.5	12.5	14.0	16.6	17.6
Net dividend payout	40.1	39.7	46.2	41.8	47.4	41.5	37.8	37.8
Free cash flow yield	n.a.	2.4	6.0	n.a.	6.6	1.9	6.3	6.1

Source: FactSet, Daiwa forecasts

Company profile

SHK Properties is currently one of the two largest property companies in Hong Kong, with substantial investments in the residential, office and retail property sectors of Hong Kong. It also has a total landbank of 49.5m sq ft in the territory. In recent years, it has been expanding into China, with major investments in the commercial property sector in Shanghai and a landbank of about 81.6m sq ft in the country.

SHKP: implied valuation

Share price (HKD)	86.95
Market cap (HKDm) = (a)	**251,725**
Completed rental properties in HK (m sq ft) = (c)	28.8
Properties under development in HK (m sq ft)	23.4
Total HK landbank = (b)	**52.2**
Implied value of HK landbank (HKD/sq ft) = (a)/(b)	**4,822**
Gross rental income in 1H FY16 (HKDm)	10,351
Estimated gross rental income in FY16 (HKDm) = (e)	21,009
Implied cap rate of rental properties* = (e)/(a)	**8.3%**
Implied value of completed HK rental properties (HKD/sq ft) = (a)/(c)**	**8,740**
Implied value of completed rental properties* (HKD/sq ft) = (a)/(c+d)**	**6,215**
Completed investment properties in China (m sq ft) = (d)	11.7
Properties under development in China (m sq ft)	58.7
Total China landbank (m sq ft)	**70.4**
Farmland in HK (m sq ft)	**>30.0**

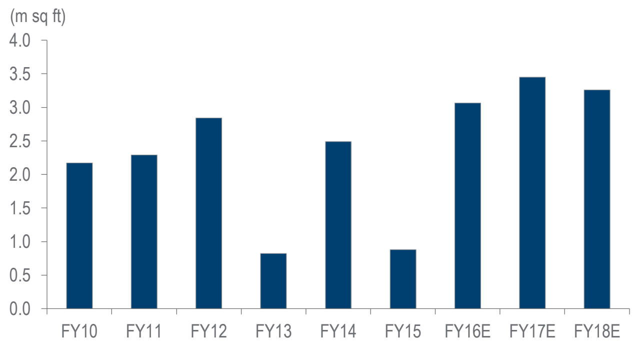
Source: Daiwa

Note: assuming no value for its rental properties under development, as well as all other assets and businesses

***assuming no value for all other assets and businesses other than completed rental properties in HK*

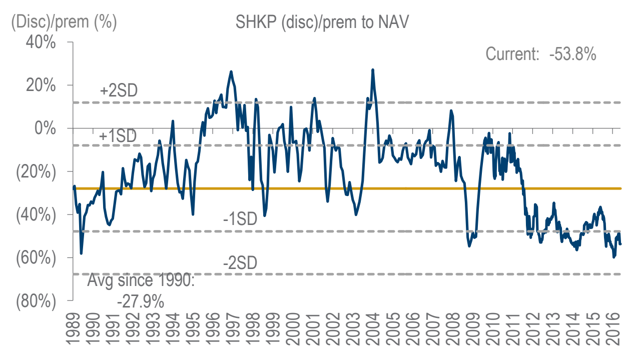
****assuming no value for all other assets and businesses other than completed rental properties in HK and China*

SHKP: residential GFA completion



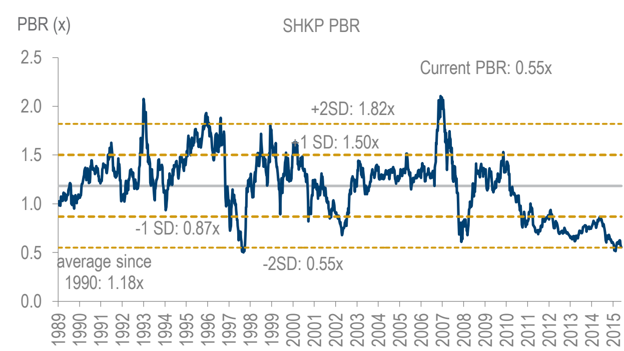
Source: Company, Daiwa forecasts

SHKP: price/NAV trend



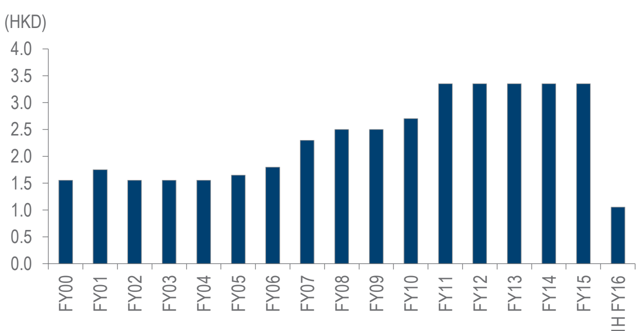
Source: Datastream, Daiwa forecasts

SHKP: PBR trend



Source: Company, Datastream, Daiwa

SHKP: DPS record



Source: Company

SHKP: gross rental income

Source: Company, Daiwa

Daiwa Capital Markets

Sino Land (83 HK)

Target price: **HKD13.00** (from HKD13.70)

Share price (23 May): **HKD11.40** | Up/downside: **+14.0%**

5 4 3 **2** 1

Outperform (unchanged)

In transition, waiting for better opportunities

- Net cash had culminated to over HKD19.4bn as at end-2015
- A lot hinges on how the company deploys surplus capital
- Reaffirming Outperform (2), trimming TP to HKD13.00

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What's new: Sino Land's FY15 DPS remains unchanged at HKD0.50. However, the company has spent around HKD35m to buy back some 3.19m shares since 2H05, which we see as a sign of progress in its capital management.

What's the impact: **One of the few companies to have engaged in share buybacks.** Sino Land's buyback scheme is slightly different than its peers in that its parent company, Tsim Sha Tsui Properties (247 HK, HKD21.00, not rated), prefers to receive scrip dividends rather than cash. As such, we believe Sino Land's share buyback scheme might also be viewed as a way to neutralise the dilutive impact of issuing new shares to pay dividends.

Dividend yield of over 4% one of the highest among major Hong Kong property companies. We estimate that since TST Properties generally opts for scrip dividends, the cash dividend paid out by Sino Land is less than what its DPS figure would suggest. Still, we forecast the dividend yield to be received by minority shareholders in 2016 to be over 4% and reckon Sino Land has kept on raising its absolute DPS over the past 10 years.

Much hinges on whether it can get the desired land at the right prices eventually. Sino Land now has positive net cash which is unprecedented for the company. We see this as a reflection of an evolution in its land-banking strategy which now seems to be more focused on getting sites with greater safety margins and greater potential to be marketed as higher upgrade products. As such, a lot will depend on whether it can secure such sites eventually, or whether it settles for being a property developer with a smaller scale of production.

What we recommend: We see Sino Land as a company in transition and a lot depends on whether it can deploy its surplus capital well. At current valuations, we reiterate our Outperform (2) rating but revise down slightly our 12-month TP to HKD13.00 (from HKD13.70), based on an unchanged 40% discount applied to our revised end-2016E NAV of HKD21.60 (previously HKD22.90). The key risk to our call: if Sino Land does not succeed in finding attractive sites to buy.

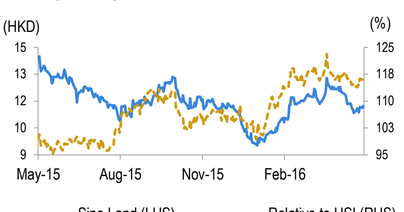
How we differ: Unlike some in the market, we do not consider Sino Land as bearish about the residential property market and see its recent land-banking strategy as an evolution of its strategy and business model.

Forecast revisions (%)

Year to 30 Jun	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	9.48-14.04
Market cap (USDbn)	8.74
3m avg daily turnover (USDm)	7.58
Shares outstanding (m)	5,960
Major shareholder	Tsimshatsui Properties (51.2%)

Financial summary (HKD)

Year to 30 Jun	16E	17E	18E
Revenue (m)	7,020	7,832	18,220
Operating profit (m)	2,834	3,190	4,327
Net profit (m)	5,590	5,630	5,920
Core EPS (fully-diluted)	0.938	0.945	0.993
EPS change (%)	5.4	0.7	5.2
Daiwa vs Cons. EPS (%)	8.7	13.4	15.2
PER (x)	12.2	12.1	11.5
Dividend yield (%)	4.6	4.7	4.9
DPS	0.520	0.540	0.560
PBR (x)	0.6	0.5	0.5
EV/EBITDA (x)	10.3	10.9	8.0
ROE (%)	4.7	4.6	4.7

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Financial summary

Key assumptions

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Rental EBIT (HKDm)	2,053	2,558	2,791	3,014	3,195	3,420	3,660	3,861
Property sales profit (HKDm)	2,066	3,017	3,299	1,854	3,405	3,607	3,620	3,740
Size of completed investment properties in HK (m sq ft)	10.0	10.1	9.9	10.0	10.0	10.2	10.2	10.3

Profit and loss (HKDm)

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales	2,149	4,279	3,359	2,741	16,957	1,925	2,541	12,730
Rental income	2,256	2,569	2,569	2,757	2,863	3,020	3,201	3,361
Other Revenue	1,539	1,548	1,891	1,953	2,019	2,075	2,090	2,129
Total Revenue	**5,944**	**8,396**	**7,819**	**7,451**	**21,839**	**7,020**	**7,832**	**18,220**
Other income	388	757	622	1,268	130	0	0	0
COGS	(1,792)	(3,217)	(3,401)	(2,340)	(16,038)	(2,323)	(2,760)	(11,985)
SG&A	(794)	(793)	(809)	(866)	(862)	(991)	(998)	(1,020)
Other op.expenses	(824)	(841)	(858)	(861)	(866)	(872)	(884)	(888)
Operating profit	**2,922**	**4,302**	**3,373**	**4,652**	**4,203**	**2,834**	**3,190**	**4,327**
Net-interest inc./(exp.)	(7)	117	238	135	298	(110)	(135)	(138)
Assoc/forex/extraord./others	2,489	1,977	3,600	1,638	2,030	4,125	3,847	3,058
Pre-tax profit	**5,404**	**6,396**	**7,211**	**6,425**	**6,531**	**6,849**	**6,902**	**7,247**
Tax	(985)	(1,050)	(538)	(1,281)	(1,126)	(1,199)	(1,210)	(1,263)
Min. int./pref. div./others	(18)	(35)	(37)	(122)	(103)	(60)	(62)	(64)
Net profit (reported)	**4,401**	**5,311**	**6,636**	**5,022**	**5,302**	**5,590**	**5,630**	**5,920**
Net profit (adjusted)	**4,401**	**5,311**	**6,636**	**5,022**	**5,302**	**5,590**	**5,630**	**5,920**
EPS (reported)(HKD)	**0.809**	**0.907**	**1.123**	**0.843**	**0.890**	**0.938**	**0.945**	**0.993**
EPS (adjusted)(HKD)	**0.809**	**0.907**	**1.123**	**0.843**	**0.890**	**0.938**	**0.945**	**0.993**
EPS (adjusted fully-diluted)(HKD)	**0.809**	**0.907**	**1.123**	**0.843**	**0.890**	**0.938**	**0.945**	**0.993**
DPS (HKD)	**0.409**	**0.460**	**0.500**	**0.500**	**0.500**	**0.520**	**0.540**	**0.560**
EBIT	**2,922**	**4,302**	**3,373**	**4,652**	**4,203**	**2,834**	**3,190**	**4,327**
EBITDA	**2,964**	**4,346**	**3,419**	**4,698**	**4,251**	**2,884**	**3,242**	**4,380**

Cash flow (HKDm)

Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	5,404	6,396	7,211	6,425	6,531	6,849	6,902	7,247
Depreciation and amortisation	42	44	46	46	48	50	52	53
Tax paid	(453)	(480)	(512)	(525)	(540)	(560)	(580)	(595)
Change in working capital	10,502	6,685	6,993	5,811	9,841	3,250	2,120	2,310
Other operational CF items	(1,046)	(2,055)	(2,294)	(633)	(2,408)	(3,235)	(2,932)	(2,000)
Cash flow from operations	**14,449**	**10,590**	**11,444**	**11,124**	**13,472**	**6,354**	**5,562**	**7,015**
Capex	(9,482)	(6,709)	(4,520)	(4,530)	(4,620)	(11,650)	(11,980)	(6,420)
Net (acquisitions)/disposals	0	0	0	0	0	0	0	0
Other investing CF items	(210)	(221)	(230)	(235)	(240)	(245)	(260)	(265)
Cash flow from investing	**(9,692)**	**(6,930)**	**(4,750)**	**(4,765)**	**(4,860)**	**(11,895)**	**(12,240)**	**(6,685)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	4,050	0	0	0	0	0	0	0
Dividends paid	(333)	(365)	(410)	(450)	(490)	(540)	(565)	(590)
Other financing CF items	(785)	(872)	(908)	(965)	(835)	(756)	(812)	(833)
Cash flow from financing	**2,932**	**(1,237)**	**(1,318)**	**(1,415)**	**(1,325)**	**(1,296)**	**(1,377)**	**(1,423)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**7,689**	**2,423**	**5,376**	**4,944**	**7,287**	**(6,837)**	**(8,055)**	**(1,093)**
Free cash flow	4,967	3,881	6,924	6,594	8,852	(5,296)	(6,418)	595

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	8,194	5,722	11,620	14,412	19,698	18,613	16,850	15,923
Inventory	1,059	1,519	966	1,618	7,483	1,130	1,150	1,190
Accounts receivable	1,283	2,520	835	1,117	2,895	1,350	1,410	1,450
Other current assets	23,768	25,586	27,355	29,600	21,127	34,560	39,046	39,825
Total current assets	**34,303**	**35,347**	**40,776**	**46,747**	**51,203**	**55,653**	**58,456**	**58,388**
Fixed assets	50,843	54,873	57,925	59,768	61,026	63,488	68,056	70,410
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	23,783	22,917	30,562	30,413	29,573	33,499	35,940	37,480
Total assets	**108,929**	**113,137**	**129,263**	**136,928**	**141,802**	**152,640**	**162,452**	**166,278**
Short-term debt	2,265	1,847	4,553	121	801	4,553	5,260	5,360
Accounts payable	3,471	3,492	3,314	3,484	8,178	4,020	4,360	4,680
Other current liabilities	2,413	1,973	5,120	7,493	3,864	5,950	6,230	6,380
Total current liabilities	**8,149**	**7,312**	**12,987**	**11,098**	**12,843**	**14,523**	**15,850**	**16,420**
Long-term debt	12,301	7,824	5,640	7,920	5,239	7,239	12,824	12,890
Other non-current liabilities	7,155	7,603	4,651	4,961	4,695	8,240	8,320	8,380
Total liabilities	**27,605**	**22,739**	**23,278**	**23,979**	**22,777**	**30,002**	**36,994**	**37,690**
Share capital	5,279	5,912	5,948	5,980	6,010	6,150	6,290	6,430
Reserves/R.E./others	75,386	83,800	98,858	105,685	112,548	115,178	117,848	120,808
Shareholders' equity	**80,665**	**89,712**	**104,806**	**111,665**	**118,558**	**121,328**	**124,138**	**127,238**
Minority interests	659	686	1,179	1,284	468	1,310	1,320	1,350
Total equity & liabilities	**108,929**	**113,137**	**129,263**	**136,928**	**141,803**	**152,640**	**162,452**	**166,278**
EV	52,279	50,445	38,189	33,453	26,087	29,734	35,378	34,971
Net debt/(cash)	**6,372**	**3,949**	**(1,427)**	**(6,371)**	**(13,658)**	**(6,821)**	**1,234**	**2,327**
BVPS (HKD)	**14.475**	**15.323**	**17.728**	**18.736**	**19.892**	**20.357**	**20.829**	**21.349**

Key ratios (%)

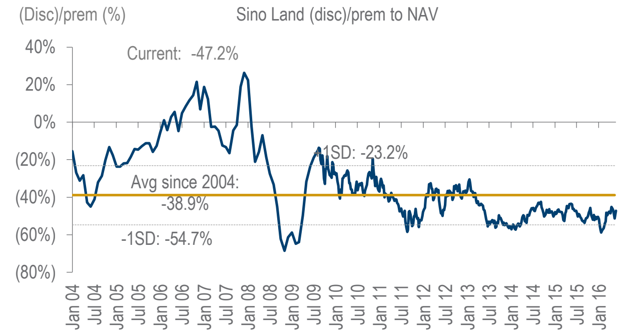
Year to 30 Jun	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	(22.8)	41.3	(6.9)	(4.7)	193.1	(67.9)	11.6	132.6
EBITDA (YoY)	(21.5)	46.6	(21.3)	37.4	(9.5)	(32.2)	12.4	35.1
Operating profit (YoY)	(21.8)	47.2	(21.6)	37.9	(9.7)	(32.6)	12.6	35.6
Net profit (YoY)	25.5	20.7	24.9	(24.3)	5.6	5.4	0.7	5.2
Core EPS (fully-diluted) (YoY)	22.5	12.1	23.7	(24.9)	5.6	5.4	0.7	5.2
Gross-profit margin	69.9	61.7	56.5	68.6	26.6	66.9	64.8	34.2
EBITDA margin	49.9	51.8	43.7	63.1	19.5	41.1	41.4	24.0
Operating-profit margin	49.2	51.2	43.1	62.4	19.2	40.4	40.7	23.7
Net profit margin	74.0	63.3	84.9	67.4	24.3	79.6	71.9	32.5
ROAE	6.0	6.2	6.8	4.6	4.6	4.7	4.6	4.7
ROAA	4.3	4.8	5.5	3.8	3.8	3.8	3.6	3.6
ROCE	3.2	4.4	3.1	3.9	3.4	2.2	2.3	3.0
ROIC	2.9	4.0	3.1	3.5	3.3	2.1	2.2	2.8
Net debt to equity	7.9	4.4	n.a.	n.a.	n.a.	n.a.	1.0	1.8
Effective tax rate	18.2	16.4	7.5	19.9	17.2	17.5	17.5	17.4
Accounts receivable (days)	70.3	82.7	78.3	47.8	33.5	110.4	64.3	28.6
Current ratio (x)	4.2	4.8	3.1	4.2	4.0	3.8	3.7	3.6
Net interest cover (x)	417.5	n.a.	n.a.	n.a.	n.a.	25.8	23.6	31.4
Net dividend payout	50.6	50.7	44.5	59.3	56.2	55.4	57.2	56.4
Free cash flow yield	7.3	5.7	10.2	9.7	13.0	n.a.	n.a.	0.9

Source: FactSet, Daiwa forecasts

Company profile

Sino Land is one of the largest property companies in Hong Kong. It focuses mainly on the residential-property sector, and also has investments in the retail and office property sectors in Hong Kong. In addition, the company has hotel and commercial-property investments in Singapore and China.

Sino Land: price/NAV trend



Source: Datastream, Daiwa estimates

Sino Land: PBR trend

Source: Company, Datastream, Daiwa

Sino Land: phases of development and share performance

Source: Bloomberg, Daiwa

Note: Ph. I (pre-2000): an outsider trying to break in to the Hong Kong property industry
Ph. II (2000-04): actively strengthened its residential landbank in Hong Kong
Ph. III (2004-07): a re-rating phase underpinned by the fruition of projects from land acquired during 2000-02
Ph. IV (2007-now): a phase for deploying cash from property sales to replenish its landbank

Sino Land: Hong Kong residential landbank (end-2015)

Project	Attributable GFA (sq ft)
Properties under development	
Kwun Tong Town Centre, Development Areas 2&3 (URA)*	1,346,383
YLTL 532, Yuen Long	497,620
Corinthia By The Sea, Tseung Kwan O (SL 60%, KW 40%)	291,936
The Mediterranean, Sai Kung	249,133
FSSTL 255, Luen Wo Hui, Fanling	209,907
The Spectra, Long Ping (SL 40%, KW 60%)	209,575
Lot 1180 in DD215, Sai Kung	173,796
NKIL 6313, Kowloon Bay (SL 30%, Billion: 40%, CSI: 30%)	147,058
Lot 1181 in DD215, Sai Kung	51,592
22 Staunton Street, Central	37,814
Lot 676 in DD, Peng Chau	36,845
Lot 674 in DD, Peng Chau	14,372
IL 9049, Sik On Street, Wan Chai	11,195
Completed properties	
Mayfair by the Sea II, Pak Shek Kok	132,139
Dragons Range, Kau To (SL 35%, Kerry 40%, Manhattan 20%)	98,570
Cluny Park, 53 Conduit Road, HK Island	60,421
Botanica Bay, Lantau	55,120
Mayfair by the Sea I, Pak Shek Kok (SL 85%, KW 15%)	54,443
Total	**3,677,919**

Source: Company

*Note: *subject to JV agreement with URA; **subject to JV agreement with MTRC*
SL=Sino Land, KW= K.Wah

Sino Land: land purchases since 2011

Award date	Usage	Location	Methods	No. of tender bids rec'd	Winning bidder(s)	Total GFA (sq ft)	Market estimated price (HKDm)	Market estimated price (HKD/sf)	Achieved price (HKDm)	Achieved price (HKD/sf)
9-Aug-11	Resi	Area 56A (site A), Kau To, Shatin	Auction	na	Kerry (40%) / Sino (40%) / Manhattan (20%)	1,031,471	7,220-9,270	7,000-8,990	5,500	5,332
16-Dec-11	Resi	Mui Wo, Lantau	Tender	2	Sino Land	49,407	84-173	1,700-3,500	55	1,113
1-Mar-12	Resi	Lot No.676, Peng Lei Rd, Peng Chau	Tender	2	Sino Land	36,845	37-92	1,000-2,500	19	516
28-Sep-12	Resi	Area 66C2, Tseung Kwan O	Tender	8	Sino Land (60%) / K.Wah (40%)	486,565	2,000-2,530	4,110-5,200	2,285	4,696
28-Sep-12	Resi	Tung Wan (Site B), Peng Chau Island	Tender	3	Sino Land	14,372	17-25	1,200-1,730	31	2,157
17-Oct-12	Resi	Long Ping Station (North), Yuen Long	Tender	8	Sino Land (40%) / K.Wah (60%)	523,938	1,572-1,886	3,000-3,600	1,708	3,260
9-Jan-13	Resi	Sha Kok Mei, Sai Kung	Tender	14	Sino Land	249,133	997-2,240	4,000-9,000	1,455	5,840
18-Sep-13	Resi	Sik On Street, Wanchai	Tender	15	Sino Land	11,195	78-112	7,000-10,000	140	12,500
6-Nov-13	Resi	Hong Tsuen Rd, Sai Kung Tuk, Sai Kung	Tender	9	Sino Land	173,796	750-835	4,315-4,804	850	4,891
1-Sep-14	Resi	Kwun Tong Town Centre Project (Areas 2 & 3), Kwun Tong (URA)	Tender	6	Sino Land (90%) / Chinese Estates (10%)	1,853,561	6,000-6,500	9,000-9,700	Not disclosed*	Not disclosed*
29-Sep-14	Resi	Junction of Luen Hing St, Wo Fung St and Luen Wo Hui, Fanling	Tender	23	Sino Land	209,909	525-693	2,500-3,300	730	3,478
29-Apr-15	Resi	Hong Kin Road, Tui Min Hoi, Sai Kung	Tender	18	Sino Land	51,592	258-413	5,000-8,000	609	11,804
13-May-15	Comm / Office	Junction of Cheung Yip St, Sheung Yee Rd and Wai Yip St, Kowloon Bay	Tender	13	Billion Dev (40%) / Sino Land (30%) / CSI Prop (30%)	490,193	2,940-3,190	6,000-6,500	3,039	6,199
25-May-15	Hotel	The Westin Sydney, 1 Martin Place, Sydney, Australia	Private bidding	Not disclosed	Sino Land (50%) / Ng family (50%)	416 rooms	na	na	2,739	6.6m/ room
23-Dec-15	Comm	Wang Yip St West/ Hong Yip St, Tung Tau Ind Area, Yuen Long	Tender	9	Sino Land	497,620	1,493 - 1,742	3,000 - 3,500	1,690	3,396

Source: Hong Kong Economic Times, Lands Department, Daiwa

*Note: * Estimated to be around HKD7.0bn, or HKD4,679/sq ft, according to Hong Kong Economic Times*

Hong Kong | Financials | 25 May 2016

Daiwa Capital Markets

Swire Properties (1972 HK)

Target price: **HKD30.70** (from HKD30.70)

Share price (23 May): **HKD19.90** | Up/downside: **+54.2%**

5 4 3 2 **1**

Buy (unchanged)

Building and riding on key locations

- Sale of Alassio should enhance earnings visibility
- Island East and Pacific Place set to become stronger locations
- Rich pipeline likely to drive earnings and NAV growth; reiterate Buy (1)

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What's new: Swire Properties (SP) has sold 181 units (out of a total of 197) of the Alassio residential development in Mid-Levels in the recent weeks. Meanwhile, Grade-A office rents and occupancy rates have held up so far in 2016. Together, we expect these factors to boost visibility on Swire's earnings through to 2017.

What's the impact: Alassio should help underpin property sales profit in 2017. We expect SP's 2016 property sales profit to come mainly from Miami, with profits from Alassio booked largely in 2017. Thereafter, the group is unlikely to realise major property sales profits from Hong Kong before its 0.7m sq ft residential property project with China Motor Bus (62 HK, Not rated) in Chai Wan starts to contribute (beyond 2020). But if SP disposes of its upcoming office projects in Kowloon East and Wong Chuk Hang, this could mitigate the potential gaps in its property sales profits.

Island East looks on track and could become the largest beneficiary of the current office-property cycle. We expect Central to be the first sub-market to see a positive breakthrough in office rents, with positive spill-over effects for Wanchai/Causeway Bay and Island East. Some IT, legal and financial companies seem to have accepted Causeway Bay as an office location for headquarters, and Island East's hopes of making the same breakthrough rest on whether the highest rent-paying industries (finance, IT, legal) can accept it as a front-office location. The ambience of the area should improve appreciably once SP has redeveloped its 3 techno-centres into 2 high-rise office buildings incorporating a scenic public square (slated to be completed by 2021). Given that SP has some 9.8m sq ft of rental properties in Island East (8.1m sq ft of which is offices), it is significantly leveraged to Island East's potential to be a commercial hub, in our view (see *Initiation: a large 'nurturing reward' awaits*, 22 May 2014).

China investments look promising. SP's malls in China achieved tenant sales growth of 3-30.3% YoY for 2015 despite the challenging market conditions. Its China gross rental income exceeded HKD2.5bn in 2015, and we expect further growth on the back of the maturing of existing projects, as well as new contributions from projects in Chengdu and Dalian.

What we recommend: We reaffirm our Buy (1) call and 12-month TP of HKD30.70 based on a 30% discount to our end-2016E NAV of HKD43.8. Risk: worse-than-expected slump in the Hong Kong and China economies.

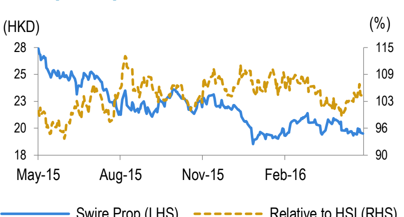
How we differ: We see SP as entering a major harvesting and reinvesting phase, which could result in it being considered a premier stock in global property. In our view, this scenario has yet to be recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	-
Net profit change	-	-	-
Core EPS (FD) change	-	-	-

Source: Daiwa forecasts

Share price performance



12-month range	18.98-27.40
Market cap (USDbn)	14.98
3m avg daily turnover (USDm)	5.73
Shares outstanding (m)	5,850
Major shareholder	Swire Pacific (82.0%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	17,573	19,352	16,985
Operating profit (m)	10,075	10,969	10,857
Net profit (m)	8,110	9,010	9,050
Core EPS (fully-diluted)	1.386	1.540	1.547
EPS change (%)	14.6	11.1	0.4
Daiwa vs Cons. EPS (%)	9.6	17.8	16.4
PER (x)	14.4	12.9	12.9
Dividend yield (%)	3.8	4.1	4.3
DPS	0.760	0.820	0.850
PBR (x)	0.5	0.5	0.5
EV/EBITDA (x)	12.6	11.7	11.9
ROE (%)	3.7	4.1	4.0

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Completed investment properties in HK (m sq ft)	12.9	13.2	13.4	13.6	13.6	13.6	13.6	14.6
Blended average rent in Pacific Place portfolio (on GFA) (HKD/sq ft)	64.9	66.0	65.9	71.0	76.7	82.1	87.5	90.0
Blended average rent in Taikoo Place portfolio (on GFA) (HKD/sq ft)	30.2	34.0	35.3	36.9	38.8	39.6	41.0	44.0
Completed investment properties in China (m sq ft)	1.6	4.7	6.0	6.0	7.0	7.1	8.9	8.9
Pay-out ratio (%)	80.3	50.6	55.2	54.0	58.7	54.8	53.2	54.9

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Gross rental income	8,557	9,015	9,677	10,456	10,716	11,125	11,746	12,625
Property trading	213	4,147	2,207	3,842	4,463	5,157	6,173	2,858
Other Revenue	811	890	1,052	1,089	1,268	1,291	1,433	1,502
Total Revenue	**9,581**	**14,052**	**12,936**	**15,387**	**16,447**	**17,573**	**19,352**	**16,985**
Other income	0	0	0	0	0	0	0	0
COGS	(2,334)	(3,770)	(3,531)	(5,176)	(5,781)	(5,883)	(6,742)	(4,456)
SG&A	(1,029)	(873)	(974)	(1,010)	(1,304)	(1,333)	(1,346)	(1,375)
Other op.expenses	(222)	(222)	(244)	(257)	(270)	(282)	(295)	(297)
Operating profit	**5,996**	**9,187**	**8,187**	**8,944**	**9,092**	**10,075**	**10,969**	**10,857**
Net-interest inc./(exp.)	(1,477)	(1,367)	(1,447)	(1,227)	(1,195)	(1,278)	(1,333)	(1,390)
Assoc/forex/extraord./others	890	453	500	505	412	738	923	1,136
Pre-tax profit	**5,409**	**8,273**	**7,240**	**8,222**	**8,309**	**9,535**	**10,560**	**10,603**
Tax	(770)	(1,199)	(769)	(892)	(1,209)	(1,401)	(1,522)	(1,523)
Min. int./pref. div./others	(267)	(142)	(111)	(178)	(22)	(24)	(28)	(30)
Net profit (reported)	**4,372**	**6,932**	**6,360**	**7,152**	**7,078**	**8,110**	**9,010**	**9,050**
Net profit (adjusted)	**4,372**	**6,932**	**6,360**	**7,152**	**7,078**	**8,110**	**9,010**	**9,050**
EPS (reported)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.386**	**1.540**	**1.547**
EPS (adjusted)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.386**	**1.540**	**1.547**
EPS (adjusted fully-diluted)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.386**	**1.540**	**1.547**
DPS (HKD)	**0.600**	**0.600**	**0.600**	**0.660**	**0.710**	**0.760**	**0.820**	**0.850**
EBIT	**5,996**	**9,187**	**8,187**	**8,944**	**9,092**	**10,075**	**10,969**	**10,857**
EBITDA	**6,218**	**9,409**	**8,431**	**9,201**	**9,362**	**10,357**	**11,264**	**11,154**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	5,409	8,273	7,240	8,222	8,309	9,535	10,560	10,603
Depreciation and amortisation	222	222	244	257	270	282	295	297
Tax paid	(485)	(875)	(615)	(842)	(983)	(1,049)	(1,232)	(1,232)
Change in working capital	415	153	167	606	3,003	2,860	1,672	1,874
Other operational CF items	139	(1,928)	808	1,264	665	350	184	30
Cash flow from operations	**5,700**	**5,845**	**7,844**	**9,507**	**11,264**	**11,978**	**11,478**	**11,572**
Capex	(5,265)	(3,004)	(7,398)	(7,890)	(6,020)	(8,250)	(8,450)	(8,690)
Net (acquisitions)/disposals	18,305	0	0	0	0	0	0	0
Other investing CF items	(1,322)	(1,367)	(145)	(165)	(185)	(194)	(214)	(214)
Cash flow from investing	**11,718**	**(4,371)**	**(7,543)**	**(8,055)**	**(6,205)**	**(8,444)**	**(8,664)**	**(8,904)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	0	0	0	0	0	0	0	0
Dividends paid	(12,439)	(2,340)	(3,393)	(3,510)	(3,744)	(4,154)	(4,505)	(4,505)
Other financing CF items	4,157	(355)	0	0	0	0	0	0
Cash flow from financing	**(8,282)**	**(2,695)**	**(3,393)**	**(3,510)**	**(3,744)**	**(4,154)**	**(4,505)**	**(4,505)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**9,136**	**(1,221)**	**(3,092)**	**(2,058)**	**1,315**	**(620)**	**(1,691)**	**(1,837)**
Free cash flow	435	2,841	446	1,617	5,244	3,728	3,028	2,882

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	1,180	1,940	2,521	2,874	4,386	3,766	3,125	3,060
Inventory	0	0	0	0	0	0	0	0
Accounts receivable	1,945	2,930	2,522	2,821	2,848	3,261	3,613	3,925
Other current assets	7,059	7,068	8,149	8,064	7,707	8,420	8,580	8,820
Total current assets	**10,184**	**11,938**	**13,192**	**13,759**	**14,941**	**15,447**	**15,318**	**15,805**
Fixed assets	6,615	6,837	7,225	7,703	8,052	8,155	8,543	8,585
Goodwill & intangibles	0	0	0	0	0	0	0	0
Other non-current assets	201,435	218,285	231,540	238,893	249,731	253,540	259,304	265,136
Total assets	**218,234**	**237,060**	**251,957**	**260,355**	**272,724**	**277,143**	**283,165**	**289,526**
Short-term debt	8,630	4,664	7,609	4,201	6,668	6,668	4,569	4,620
Accounts payable	8,088	7,155	8,007	7,674	8,943	9,319	9,860	10,230
Other current liabilities	445	710	211	519	1,133	1,156	1,230	1,256
Total current liabilities	**17,163**	**12,529**	**15,827**	**12,394**	**16,744**	**17,143**	**15,659**	**16,106**
Long-term debt	20,250	26,197	26,946	32,744	30,474	30,474	33,622	35,343
Other non-current liabilities	4,246	5,078	6,054	6,670	7,557	7,825	7,920	7,980
Total liabilities	**41,659**	**43,804**	**48,827**	**51,808**	**54,775**	**55,442**	**57,201**	**59,429**
Share capital	5,850	5,850	5,850	10,449	10,449	10,449	10,449	10,449
Reserves/R.E./others	170,193	186,764	196,500	197,242	205,798	209,462	213,675	217,753
Shareholders' equity	**176,043**	**192,614**	**202,350**	**207,691**	**216,247**	**219,911**	**224,124**	**228,202**
Minority interests	532	642	800	856	1,702	1,790	1,840	1,895
Total equity & liabilities	**218,234**	**237,060**	**251,977**	**260,355**	**272,724**	**277,143**	**283,165**	**289,526**
EV	131,008	130,379	132,349	132,600	130,947	130,686	131,663	132,853
Net debt/(cash)	**27,700**	**28,921**	**32,034**	**34,071**	**32,756**	**33,376**	**35,066**	**36,903**
BVPS (HKD)	**30.093**	**32.925**	**34.590**	**35.503**	**36.965**	**37.592**	**38.312**	**39.009**

Key ratios (%)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	8.0	46.7	(7.9)	18.9	6.9	6.8	10.1	(12.2)
EBITDA (YoY)	9.1	51.3	(10.4)	9.1	1.7	10.6	8.8	(1.0)
Operating profit (YoY)	9.5	53.2	(10.9)	9.2	1.7	10.8	8.9	(1.0)
Net profit (YoY)	14.1	58.6	(8.3)	12.5	(1.0)	14.6	11.1	0.4
Core EPS (fully-diluted) (YoY)	n.a.	58.6	(8.3)	12.5	(1.0)	14.6	11.1	0.4
Gross-profit margin	75.6	73.2	72.7	66.4	64.9	66.5	65.2	73.8
EBITDA margin	64.9	67.0	65.2	59.8	56.9	58.9	58.2	65.7
Operating-profit margin	62.6	65.4	63.3	58.1	55.3	57.3	56.7	63.9
Net profit margin	45.6	49.3	49.2	46.5	43.0	46.2	46.6	53.3
ROAE	2.6	3.8	3.2	3.5	3.3	3.7	4.1	4.0
ROAA	2.1	3.0	2.6	2.8	2.7	2.9	3.2	3.2
ROCE	3.0	4.3	3.5	3.7	3.6	3.9	4.2	4.1
ROIC	2.6	3.7	3.2	3.3	3.1	3.4	3.6	3.5
Net debt to equity	15.7	15.0	15.8	16.4	15.1	15.2	15.6	16.2
Effective tax rate	14.2	14.5	10.6	10.8	14.5	14.7	14.4	14.4
Accounts receivable (days)	59.3	63.3	76.9	63.4	62.9	63.4	64.8	81.0
Current ratio (x)	0.6	1.0	0.8	1.1	0.9	0.9	1.0	1.0
Net interest cover (x)	4.1	6.7	5.7	7.3	7.6	7.9	8.2	7.8
Net dividend payout	80.3	50.6	55.2	54.0	58.7	54.8	53.2	54.9
Free cash flow yield	0.4	2.4	0.4	1.4	4.5	3.2	2.6	2.5

Source: FactSet, Daiwa forecasts

Company profile

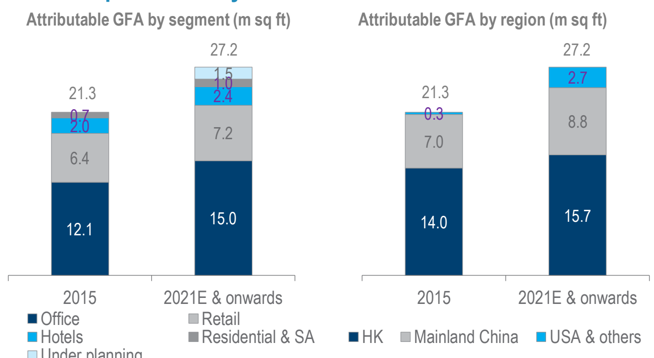
Swire Properties is the property arm of Swire Pacific, one of the largest and oldest conglomerates in Hong Kong. The company is a leading developer, owner, and operator of mixed-use developments, principally commercial properties in Hong Kong, Mainland China, and the US. At the end of 2013, it owned some 20.2m sq ft attributable GFA of completed commercial properties and had a significant presence in 2 locations in Hong Kong: Admiralty (where it has built the Pacific Place) and Island East (Taikoo Place). Swire Properties was listed on the Hong Kong stock market in January 2012.

Swire Properties: details of Alassio project

	ALASSIO
District	Mid-Levels
Total no. of units	197
Net sizes (sq ft)	544 - 1,007 for the standard units 1,149 - 3,118 for the special units
Est'd completion	2Q17
Units with prices published	194
Per unit price range (HKD)	15m - 77m
Psf price range (HKD)	24,208 - 45,212
Psf price (HKD)	29,673
Max. discount / tax rebates	12%
Total units launched	188
Sales start date	13 Apr 2016
Units sold	181
Sales proceeds raised (HKD)	4.0bn
Sales through rate (%)	96%

Source: Company, Daiwa

Swire Properties: five years later



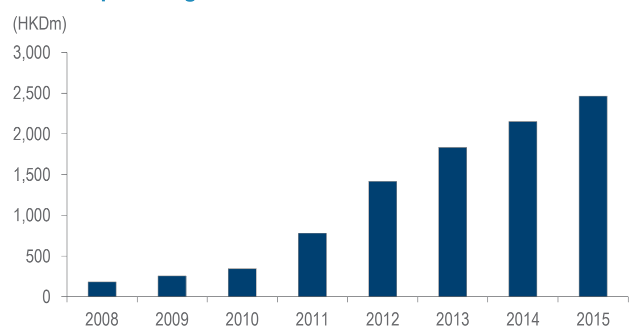
Source: Company; Note: E = Swire guidance

Swire Properties: breakdown of gross rental income

	1H14 (HKDm)	2H14 (HKDm)	2014 (HKDm)	1H15 (HKDm)	2H15 (HKDm)	2015 (HKDm	YoY chg
Gross rental income by business segment*							
Office	2,790	2,917	5,707	2,994	2,978	5,972	4.6%
Retail	2,086	2,174	4,260	2,187	2,179	4,366	2.5%
Residential	169	184	353	187	191	378	7.1%
Total	**5,045**	**5,275**	**10,320**	**5,368**	**5,348**	**10,716**	**3.8%**
Gross rental income by geography*							
Hong Kong	4,136	4,263	8,398	4,345	4,330	8,675	3.3%
China	899	998	1,897	1,010	1,004	2,014	6.2%
Others	10	15	25	13	14	27	8.0%
Total	**5,045**	**5,275**	**10,320**	**5,368**	**5,348**	**10,716**	**3.8%**

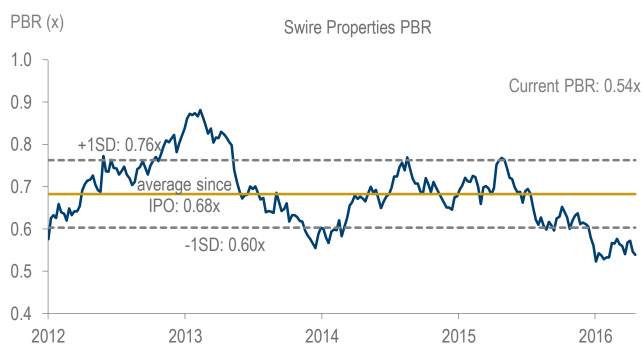
Source: Company, Daiwa; Note: excluding rental income from associates and JCEs

Swire Properties: gross rental income from China



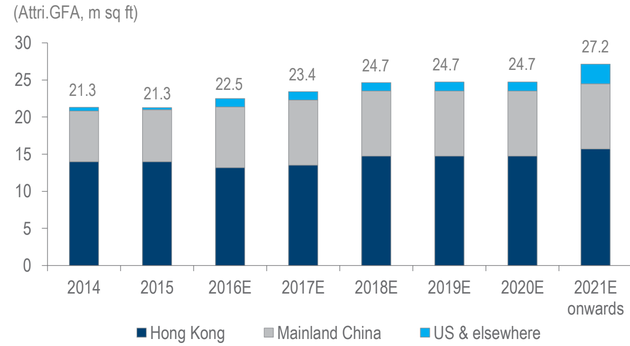
Source: Company, Daiwa

Swire Properties: PBR



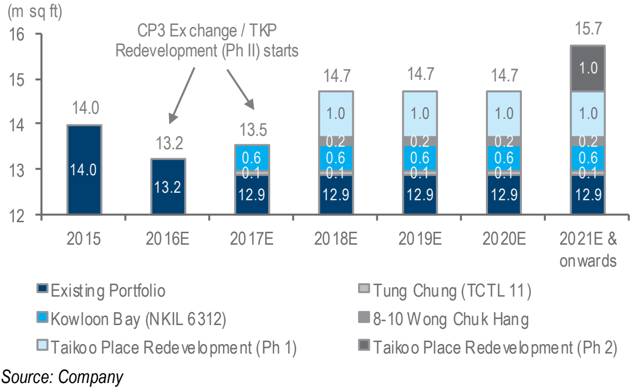
Source: Company, Datastream, Daiwa forecasts; note: with SP shares trading near historical low PBR levels, Daiwa recently picked SP as a Fallen Angel, which is a company whose share-price decline is transitory in nature and that features a sustainable business model that produces superior returns (see Fallen Angels , 24 February 2016).

Swire Properties: expected attributable GFA of completed investment properties



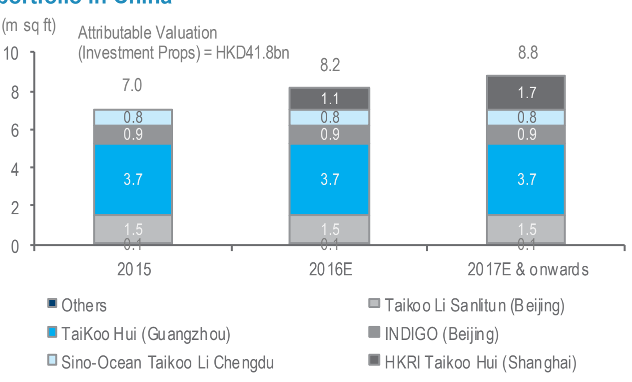
Source: Company
Note: As at 31 Dec 2015; E = Swire guidance

Swire Properties: expected attributable GFA of completed property portfolio in Hong Kong



Source: Company
Note: E = company guidance

Swire Properties: attributable GFA of completed property portfolio in China



Source: Company
Note: E = company guidance

Wharf Holdings (4 HK)

Target price: **HKD63.50** (from HKD63.50)

Share price (23 May): **HKD41.35** | Up/downside: **+53.5%**

Buy
(unchanged)

More than 2 malls; more than just luxury retail

- Continues to sharpen its focus on investment-property business
- Promising start for Chengdu IFS; China investments coming to fruition
- Subdued sentiment set against sound fundamentals; Buy (1) reaffirmed

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What's new: Wharf announced on 14 March that it has acquired Wheelock House for HKD6.2bn, which we see as part of the company's overall strategy of putting a greater emphasis on its investment-property (IP) business. In our view, this initiative will enhance Wharf's earnings visibility.

What's the impact: **The strategic shift should be positive for DPS**, as its quality IPs generate sizeable recurrent cash flow. Wharf's DPS has seen a CAGR of 9% since 2005, and the company raised its DPS by 5% YoY for 2015, against a 5% YoY rise in underlying net profit.

Entering the start of the harvesting phase for its China investments. Chengdu IFS has made a promising start, with the mall having achieved CNY3.3bn in retail sales in its first full year of operation, making it one of the most successful IP projects undertaken by Hong Kong companies in China so far. Much depends on whether the execution of its China projects is as good as it was for Chengdu IFS, but we believe the pipeline is full until 2020 and the company's focus is on getting its China assets to generate more cash, rather than buying more land. In 2015, its net debt fell by HKD12bn YoY, reducing its net gearing by 4pp to 15%.

Hong Kong retail remains challenging, especially considering that Wharf's 2 malls in Hong Kong had a good run from 2004-14. That said, we think Harbour City and Times Square are more than simply luxury retail malls, as both are intensively managed and continue to evolve. Given their very high base (in terms of achieved tenant sales), we think it will take time for its tenant sales to see a return of growth momentum. Still, the group has many premier assets (including Hong Kong offices, China malls, and ports). Moreover, if its China investments continue to bear fruit, Wharf's vulnerability to weakness at its 2 malls should continue to decline.

What we recommend: We continue to see Wharf as an asset play and hence believe it should not be priced only as a play on its 2 malls. We see considerable value in the stock, as Harbour City alone is worth HKD171bn on the book and the implied cap rate for its quality IP portfolio is over 10%. We reaffirm our Buy (1) call and TP of HKD63.50, based on a 40% discount applied to our end-2016E NAV of HKD105.8/share. The key risk: a bigger-than-expected fall in retail spending in Hong Kong.

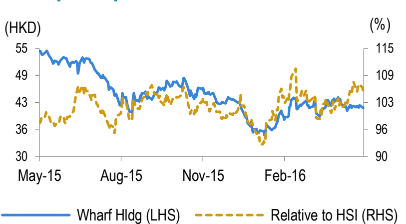
How we differ: We see Wharf as a quality asset play that is being transformed into a premier owner and manager of IP, which should be structurally positive for its valuation even in the face of the cyclical headwinds facing its malls in Hong Kong. This change in Wharf's profile may not be fully recognised by the market.

Forecast revisions (%)

Year to 31 Dec	16E	17E	18E
Revenue change	-	-	n.a.
Net profit change	-	-	n.a.
Core EPS (FD) change	-	-	n.a.

Source: Daiwa forecasts

Share price performance



12-month range	34.85-54.45
Market cap (USDbn)	16.13
3m avg daily turnover (USDm)	25.12
Shares outstanding (m)	3,030
Major shareholder	Wheelock and Company (60.0%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	41,331	46,855	49,687
Operating profit (m)	16,380	18,421	20,203
Net profit (m)	12,270	13,870	15,480
Core EPS (fully-diluted)	4.050	4.578	5.109
EPS change (%)	6.4	13.0	11.6
Daiwa vs Cons. EPS (%)	0.4	11.3	18.2
PER (x)	10.2	9.0	8.1
Dividend yield (%)	4.8	5.1	5.3
DPS	2.000	2.100	2.200
PBR (x)	0.4	0.4	0.4
EV/EBITDA (x)	8.0	7.0	6.2
ROE (%)	3.9	4.4	4.7

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Financial summary

Key assumptions

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Gross rental income (HKDm)	9,941	9,880	11,133	13,397	14,470	15,163	16,492	17,071
Rental EBIT (HKDm)	7,320	8,187	9,268	10,896	11,759	12,827	13,916	14,678
China property sales profit (HKDm)	2,274	3,562	2,565	1,669	2,266	2,525	3,263	3,518
Size of completed investment properties in HK (m sq ft)	11.7	11.7	11.7	12.2	12.2	12.2	12.2	12.2

Profit and loss (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Property sales	6,343	12,207	11,514	15,539	18,018	18,035	21,751	23,456
Rental income	6,552	7,229	11,133	13,397	14,470	15,163	16,492	17,071
Other Revenue	11,109	11,420	9,240	9,200	8,387	8,133	8,612	9,160
Total Revenue	**24,004**	**30,856**	**31,887**	**38,136**	**40,875**	**41,331**	**46,855**	**49,687**
Other income	288	134	358	250	265	275	280	284
COGS	(9,095)	(14,808)	(16,512)	(21,589)	(23,383)	(22,796)	(26,194)	(27,186)
SG&A	(2,414)	(550)	(934)	(738)	(790)	(850)	(890)	(902)
Other op.expenses	(1,395)	(1,462)	(1,520)	(1,560)	(1,548)	(1,580)	(1,630)	(1,680)
Operating profit	**11,388**	**14,170**	**13,279**	**14,499**	**15,419**	**16,380**	**18,421**	**20,203**
Net-interest inc./(exp.)	(1,211)	(939)	(1,077)	(1,701)	(1,879)	(1,533)	(1,470)	(1,323)
Assoc/forex/extraord./others	852	2,114	2,716	(747)	2,108	1,675	1,606	1,718
Pre-tax profit	**11,029**	**15,345**	**14,918**	**12,051**	**15,648**	**16,522**	**18,557**	**20,598**
Tax	(2,403)	(3,204)	(2,869)	(3,081)	(3,344)	(3,470)	(3,897)	(4,323)
Min. int./pref. div./others	(543)	(1,101)	(751)	(494)	(772)	(782)	(790)	(795)
Net profit (reported)	**8,083**	**11,040**	**11,298**	**8,476**	**11,532**	**12,270**	**13,870**	**15,480**
Net profit (adjusted)	**8,083**	**11,040**	**11,298**	**8,476**	**11,532**	**12,270**	**13,870**	**15,480**
EPS (reported)(HKD)	**2.718**	**3.645**	**3.730**	**2.798**	**3.806**	**4.050**	**4.578**	**5.109**
EPS (adjusted)(HKD)	**2.718**	**3.645**	**3.730**	**2.798**	**3.806**	**4.050**	**4.578**	**5.109**
EPS (adjusted fully-diluted)(HKD)	**2.669**	**3.645**	**3.730**	**2.798**	**3.806**	**4.050**	**4.578**	**5.109**
DPS (HKD)	**1.060**	**1.650**	**1.700**	**1.810**	**1.900**	**2.000**	**2.100**	**2.200**
EBIT	**11,388**	**14,170**	**13,279**	**14,499**	**15,419**	**16,380**	**18,421**	**20,203**
EBITDA	**12,783**	**15,632**	**14,799**	**16,059**	**16,967**	**17,960**	**20,051**	**21,883**

Cash flow (HKDm)

Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Profit before tax	11,029	15,345	14,918	12,051	15,648	16,522	18,557	20,598
Depreciation and amortisation	1,395	1,462	1,520	1,560	1,548	1,580	1,630	1,680
Tax paid	(2,403)	(3,204)	(2,869)	(2,773)	(3,010)	(3,123)	(3,507)	(3,891)
Change in working capital	4,820	7,647	10,360	13,259	19,080	14,380	14,520	14,545
Other operational CF items	1,286	(640)	(1,039)	1,115	1,189	628	664	405
Cash flow from operations	**16,127**	**20,610**	**22,890**	**25,212**	**34,455**	**29,987**	**31,864**	**33,337**
Capex	(32,108)	(32,900)	(19,120)	(19,078)	(14,560)	(17,325)	(18,440)	(19,860)
Net (acquisitions)/disposals	249	5,262	302	285	290	298	298	302
Other investing CF items	(19)	(21)	(23)	(28)	(28)	(30)	(32)	(34)
Cash flow from investing	**(31,878)**	**(27,659)**	**(18,841)**	**(18,821)**	**(14,298)**	**(17,057)**	**(18,174)**	**(19,592)**
Change in debt	0	0	0	0	0	0	0	0
Net share issues/(repurchases)	10,052	0	0	0	0	0	0	0
Dividends paid	(3,450)	(3,938)	(5,149)	(5,452)	(5,755)	(6,058)	(6,361)	(6,664)
Other financing CF items	(1,627)	(1,174)	(1,346)	(2,126)	(2,349)	(1,916)	(1,838)	(1,654)
Cash flow from financing	**4,975**	**(5,111)**	**(6,496)**	**(7,578)**	**(8,104)**	**(7,974)**	**(8,198)**	**(8,318)**
Forex effect/others	0	0	0	0	0	0	0	0
Change in cash	**(10,776)**	**(12,160)**	**(2,447)**	**(1,187)**	**12,054**	**4,956**	**5,491**	**5,428**
Free cash flow	(15,981)	(12,290)	3,770	6,134	19,895	12,662	13,424	13,477

Source: FactSet, Daiwa forecasts

Financial summary continued …

Balance sheet (HKDm)

As at 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Cash & short-term investment	32,528	18,795	24,515	18,725	23,510	23,890	24,120	26,655
Inventory	130	45	47	48	46	53	60	63
Accounts receivable	3,420	4,796	4,456	3,851	3,974	4,210	4,456	4,820
Other current assets	47,736	49,354	54,083	47,826	38,104	41,216	40,695	42,371
Total current assets	**83,814**	**72,990**	**83,101**	**70,450**	**65,634**	**69,369**	**69,331**	**73,909**
Fixed assets	203,041	251,392	285,258	326,917	332,956	332,852	338,849	344,257
Goodwill & intangibles	297	297	297	305	305	305	305	305
Other non-current assets	30,821	44,319	46,396	46,986	45,021	43,322	42,020	40,488
Total assets	**317,973**	**368,998**	**415,052**	**444,658**	**443,916**	**445,848**	**450,505**	**458,959**
Short-term debt	8,903	5,330	9,502	8,653	8,463	8,250	8,190	8,130
Accounts payable	10,316	14,801	20,089	23,664	22,681	23,120	23,658	23,890
Other current liabilities	11,537	12,849	17,154	17,088	20,708	21,045	22,356	23,890
Total current liabilities	**30,756**	**32,980**	**46,745**	**49,405**	**51,852**	**52,415**	**54,204**	**55,910**
Long-term debt	67,090	69,090	73,085	69,331	62,244	57,890	52,689	49,856
Other non-current liabilities	9,253	10,022	10,967	11,811	12,640	12,120	12,425	12,650
Total liabilities	**107,099**	**112,092**	**130,797**	**130,547**	**126,736**	**122,425**	**119,318**	**118,416**
Share capital	3,029	3,029	3,030	29,376	29,441	29,441	29,441	29,441
Reserves/R.E./others	200,228	245,472	272,527	276,119	278,287	284,347	292,006	301,276
Shareholders' equity	**203,257**	**248,501**	**275,557**	**305,495**	**307,728**	**313,788**	**321,447**	**330,717**
Minority interests	7,617	8,405	8,698	8,616	9,452	9,635	9,740	9,826
Total equity & liabilities	**317,973**	**368,998**	**415,052**	**444,658**	**443,916**	**445,848**	**450,505**	**458,959**
EV	149,241	153,118	153,271	151,687	146,543	143,920	139,940	136,190
Net debt/(cash)	**43,465**	**55,625**	**58,072**	**59,259**	**47,197**	**42,250**	**36,759**	**31,331**
BVPS (HKD)	**67.104**	**82.041**	**90.973**	**100.857**	**101.560**	**103.560**	**106.088**	**109.147**

Key ratios (%)

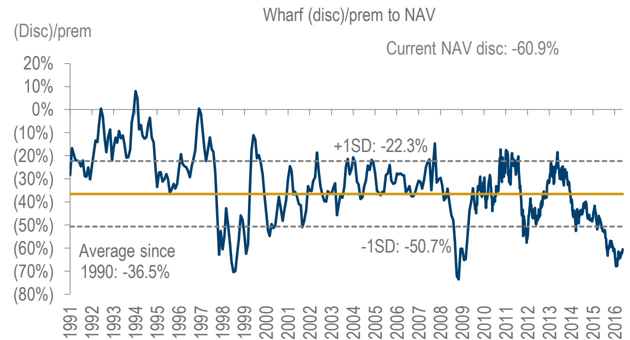
Year to 31 Dec	2011	2012	2013	2014	2015	2016E	2017E	2018E
Sales (YoY)	23.9	28.5	3.3	19.6	7.2	1.1	13.4	6.0
EBITDA (YoY)	19.5	22.3	(5.3)	8.5	5.7	5.9	11.6	9.1
Operating profit (YoY)	21.5	24.4	(6.3)	9.2	6.3	6.2	12.5	9.7
Net profit (YoY)	2.3	36.6	2.3	(25.0)	36.1	6.4	13.0	11.6
Core EPS (fully-diluted) (YoY)	(7.0)	36.6	2.3	(25.0)	36.0	6.4	13.0	11.6
Gross-profit margin	62.1	52.0	48.2	43.4	42.8	44.8	44.1	45.3
EBITDA margin	53.3	50.7	46.4	42.1	41.5	43.5	42.8	44.0
Operating-profit margin	47.4	45.9	41.6	38.0	37.7	39.6	39.3	40.7
Net profit margin	33.7	35.8	35.4	22.2	28.2	29.7	29.6	31.2
ROAE	4.4	4.9	4.3	2.9	3.8	3.9	4.4	4.7
ROAA	2.9	3.2	2.9	2.0	2.6	2.8	3.1	3.4
ROCE	4.5	4.6	3.8	3.8	4.0	4.2	4.7	5.1
ROIC	3.9	4.0	3.3	3.0	3.3	3.5	4.0	4.3
Net debt to equity	21.4	22.4	21.1	19.4	15.3	13.5	11.4	9.5
Effective tax rate	21.8	20.9	19.2	25.6	21.4	21.0	21.0	21.0
Accounts receivable (days)	52.7	48.6	53.0	39.8	34.9	36.1	33.8	34.1
Current ratio (x)	2.7	2.2	1.8	1.4	1.3	1.3	1.3	1.3
Net interest cover (x)	9.4	15.1	12.3	8.5	8.2	10.7	12.5	15.3
Net dividend payout	39.0	45.3	45.6	64.7	49.9	49.4	45.9	43.1
Free cash flow yield	n.a.	n.a.	3.0	4.9	15.9	10.1	10.7	10.8

Source: FactSet, Daiwa forecasts

Company profile

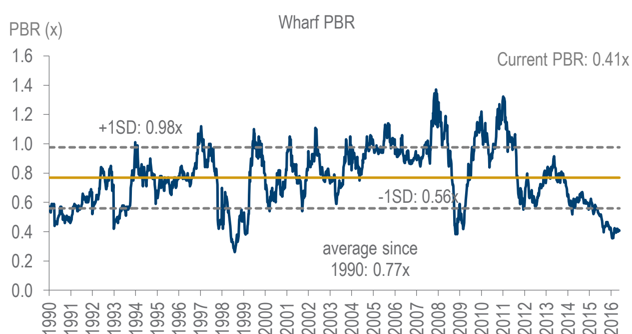
Wharf is one of the largest property investors in Hong Kong, with its two key properties, Harbour City and Times Square, accounting for more than 60% of its assets and operating profit. In addition to its investment-property portfolio, the company has investments in ports, as well as the media and telecom sectors. In recent years, it has been expanding its investments in China and has a long-term target of having about half of its assets in Hong Kong and half in the Mainland.

Wharf: price/NAV trend



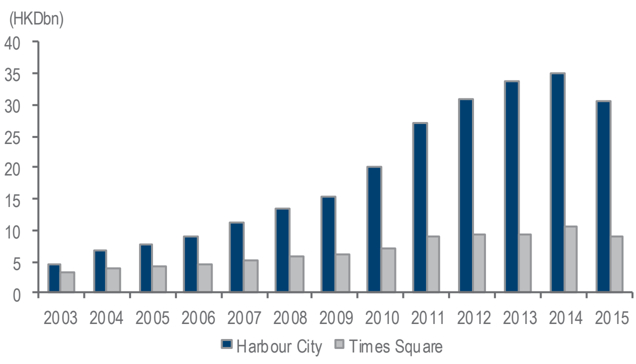
Source: Datastream, Daiwa estimates

Wharf: PBR trend



Source: Company, Datastream, Daiwa

Wharf: retail sales in Harbour City and Times Square



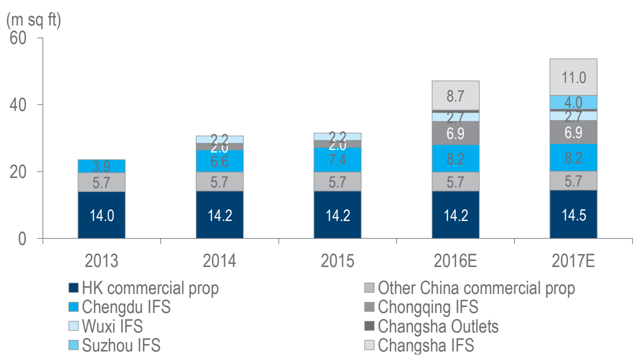
Source: Company, Daiwa

Wharf: YoY change in retail sales vs. Hong Kong retail sales

		Harbour City		Times Square		HK overall	
		(HKDbn)	(YoY)	(HKDbn)	(YoY)	(HKDbn)	(YoY)
2013	1Q	8.5	14.9%	2.3	-4.2%	129.3	13.9%
	2Q	7.5	11.9%	2.0	0.0%	123.6	16.1%
	3Q	8.1	8.0%	2.2	0.0%	114.5	7.5%
	4Q	9.8	6.5%	2.9	7.4%	127.1	6.8%
	FY	**33.8**	**9.7%**	**9.4**	**1.1%**	**494.4**	**11.0%**
2014	1Q	9.1	7.1%	2.8	21.7%	134.6	4.2%
	2Q	7.7	2.7%	2.4	20.0%	115.0	-7.0%
	3Q	8.6	6.2%	2.5	13.6%	116.3	1.6%
	4Q	9.6	-2.0%	2.8	-3.4%	127.3	0.2%
	FY	**35.0**	**3.4%**	**10.5**	**11.1%**	**493.2**	**-0.2%**
2015	1Q	8.6	-5.5%	2.6	-7.1%	131.6	-2.3%
	2Q	7.0	-9.1%	2.1	-12.5%	114.0	-0.9%
	2H	15.1	-17.0%	4.4	-17.0%	229.6	-5.8%
	FY	**30.7**	**-12.1%**	**9.1**	**-12.8%**	**475.2**	**-3.7%**
2016	1Q	n.d.	-19%	n.d.	-20%	115.2	-12.5%

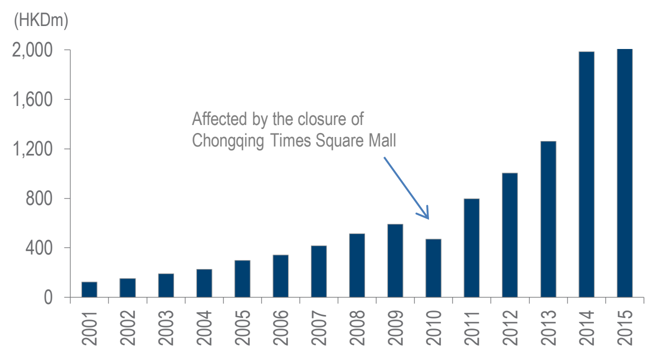
Source: Company, Daiwa
Note: n.d. = not disclosed

Wharf: commercial properties completion schedule (Dec 2015)



Source: Company
Note: E = Wharf guidance

Wharf: gross rental income from China



Source: Company, Daiwa

Daiwa Capital Markets

Great Eagle (41 HK)

Target price: **n.a.**

Share price (23 May): **HKD28.75** | Up/downside: **-**

5 4 3 2 1

No Rating

Evolving corporate structure and capital management

- Balance sheet issues resolved after its 2 spin-offs
- Market still awaiting clear signal as to its future strategy and focus
- Paid HKD2.0/share special dividend in its 2015 results

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Background: Great Eagle is one of the oldest property companies in Hong Kong, having been involved in the business since the 1960s. In the 1980s, it committed to 2 large-scale commercial property projects (Citibank Plaza and Langham Place), which stretched its balance sheet. In 2007, it spun off Champion REIT as the holding company of Citibank Plaza, and subsequently injected the retail and office portion of Langham Place into the REIT. In 2013, it spun off Langham Hospitality as the holding company of its 3 hotel assets in Hong Kong. As a result, Great Eagle's major assets currently are its 62.8% stake in Champion REIT (2778 HK, HKD3.97, Buy [1]) and 61.0% stake in Langham Hospitality (1270 HK, not rated).

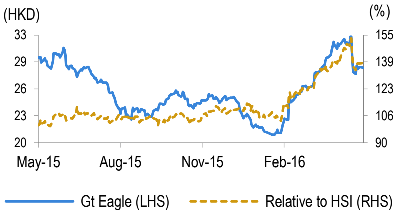
Highlights: The balance sheet issue is now over, as the 2 spin-offs enabled Great Eagle to offload its debt, enabling it to return to a net cash position. In 2015, it received a total dividend from Champion REIT and Langham Hospitality amounting to around HKD932m, and on top of this, it also receives an annual management fee from these 2 assets.

Market awaiting clarity on new investments. Since the early 2010s, Great Eagle has acquired various assets, such as office properties in the US, hotels and mixed property development projects in China, a US real-estate fund and a residential project in Pak Shek Kok, Hong Kong. However, the market seems to be waiting for more clarity on its future investments. In the meantime, Great Eagle has paid higher dividends than in the past, including a HKD2/share special dividend per its 2015 results.

Management keen to develop overseas hotels. The group has long stated its ambitions to develop its hotel businesses and have a hotel management business as well.

Valuation: Based on the current unit prices of Champion REIT and Langham Hospitality, the combined market value of Great Eagle's stakes in these 2 entities is now HKD17.7bn, which translates into HKD26.50 per Great Eagle share. Based on its end-2015 adjusted BVPS of HKD94.50, the stock is trading at a PBR of 0.30x, vs. an average of 0.5x since 1990. Based on its DPS of HKD0.74 for 2015, the stock is trading currently at a dividend yield of 2.6%. Were its HKD2 special dividend is to be included, its dividend yield would rise to 9.5%.

Share price performance



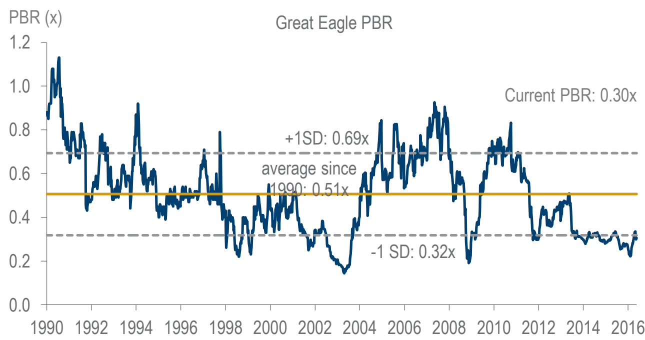
12-month range	20.90-32.30
Market cap (USDbn)	2.47
3m avg daily turnover (USDm)	1.64

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Company

Great Eagle: PBR



Source: Company, Daiwa

Great Eagle: hotel portfolio

	No of rooms
Owned by subsidiary LHI	
The Langham, Hong Kong	409
Cordis, Hong Kong	620
Eaton, Hong Kong	465
Wholly-owned	
The Langham, London	341
The Langham, Melbourne	388
The Langham, Auckland	409
The Langham, Sydney	88
The Langham, Boston	318
The Langham Huntington, Pasadena	380
The Langham, Chicago	316
Chelsea Hotel, Toronto	1,590
Langham Place, Fifth Avenue, New York	214
The Langham, Xintiandi, Shanghai	357
Total	**5,895**

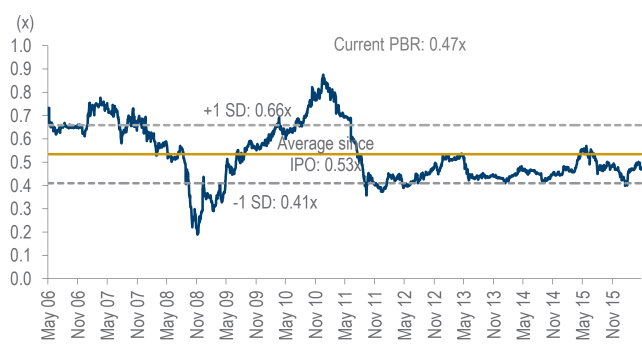
Source: Company

Great Eagle: hotel pipeline

	No. of rooms	Status
2016		
The Langham Haikou	249	Agreement
Cordis Qingdao	538	Agreement
2017		
Langham Place, Changsha	300	Agreement
Cordis Shanghai East Bund	155	Agreement
The Langham Chongqing	144	Agreement
The Langham Hefei	338	Agreement
2018		
Langham Place Bali	120	Agreement
Langham Place Dubai	167	Agreement
Langham Place Lusail Doha	236	Agreement
The Langham Jakata	210	Agreement
Langham Place Wade Park	233	Agreement
The Langham Sante Fe	105	Agreement
2019		
Langham Place Dalian	361	Agreement
The Langham Dara Sakor Cambodia	200	Agreement
Total	**3,356**	

Source: Company

Champion REIT: PBR



Source: Bloomberg, Company, Daiwa

Daiwa Capital Markets

Kerry Properties (683 HK)

Target price: **n.a.**

Share price (23 May): **HKD19.30** | Up/downside: **-**

5 4 3 2 1

No Rating

Building up prime property assets

- Owner and developer of prime properties in Hong Kong and China
- Backed by cash flow from developing properties for sale
- China gross rental income reached HKD2.9bn in 2015

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Background: Kerry Properties (Kerry) is a part of the Malaysia-based Kerry Group, which is a conglomerate with diversified investments encompassing hotels, trading, sugar and logistics, across Asia. In Hong Kong, it is primarily focused on owning prime properties for rent, but it has also gradually built up its presence in the business of developing residential properties for sale, especially in the luxury and higher-end segments. Currently, Kerry is one of the largest luxury residential property landlords in Hong Kong, with 0.7m sq ft of luxury residential properties, mainly in the Mid-levels area. It is also one of the largest foreign investors in China property, with 6.7m sq ft of completed commercial properties in 5 major cities in China, and some 28.8m sq ft of properties under development.

Highlights: A reputable brand in the residential property market. Kerry was originally well known as the landlord of a number of prime luxury residential properties in Mid-levels, and gradually moved on to build up its presence in the business of developing luxury residential properties for sale. Since 2013, it has completed various projects known in the market for their quality, such as Lions Rise, 1-3 Ede Road and Dragons Range. In recent months, it has started selling its 2 major projects in Hong Kong. One is The Bloomsway in Tuen Mun, which is a 0.94m sq ft development near the Harrow International School. Another is Mantin Heights, which is a 1.1m sq ft development that started selling in April 2016.

One of the largest commercial landlords in China. At end-2015, Kerry had 6.7m sq ft of completed investment properties in China, as well as 13.3m sq ft of investment properties under development, located in Shenzhen, Hangzhou, Nancheng, Shenyang, Jinan, Kunming and Zhengzhou. In 2015, its China gross rental income rose by 26% YoY to HKD2.9bn, making it one of the largest commercial landlords in China in terms of gross rental income.

Using proceeds from developing residential properties to fund its expanding rental portfolio, especially in China. Kerry now has some 2.7m sq ft of development landbank in Hong Kong and 15.5m sq ft of properties under development for sale in China. According to management, over the years, the group has been using the sales proceeds raised from property development to fund the continued expansion of its rental portfolio, especially in major cities in China where it has many large-scale, mixed property development projects.

Valuation: Kerry's reported BVPS at end-2015 was HKD56.27 and it is trading currently at a PBR of 0.34x, vs. its past-20-year average of 0.7x.

Share price performance

(HKD) 34, 30, 25, 21, 16 — (%) 105, 96, 88, 79, 70

May-15 Aug-15 Nov-15 Feb-16

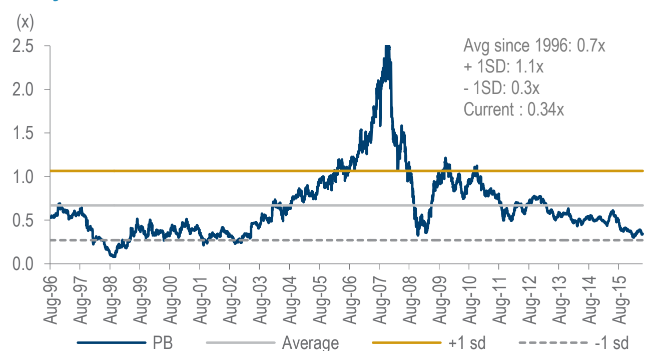
Kerry Prop (LHS) ---- Relative to HSI (RHS)

12-month range	16.96-33.90
Market cap (USDbn)	3.58
3m avg daily turnover (USDm)	5.30

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

Kerry: PBR



Source: Bloomberg, Daiwa

Kerry: commercial investment property portfolio in HK

Property	Attri. Interest	Attri. GFA (sq ft) Office	Comm	Hotel	Total
Enterprise Square V / Megabox	100%	519,316	1,145,537	-	1,664,853
Enterprise Square	100%	56,730	-	-	56,730
Kerry Centre	40%	193,252	10,952	-	204,204
Hollywood Centre	47%	36,034	11,300	-	47,334
Harbour Centre*	16%	34,767	6,475	-	41,242
Enterprise Square III	100%	-	19,800	-	19,800
Island Crest	100%	-	15,891	-	15,891
South Seas Centre	100%	-	6,341	-	6,341
Belair Monte	8%	-	3,820	-	3,820
Wing On Plaza	10%	-	2,896	-	2,896
Hotel Jen Hong Kong	30%	-	-	37,517	37,517
Total		**840,099**	**1,223,012**	**37,517**	**2,100,628**

Source: Company
*Note: *net floor area*

Kerry: investment property portfolio in HK

	Attributable GFA ('000 sq ft)
Apartment	722
Commercial	1,223
Office	840
Hotel	38
Total	**2,823**

Source: Company

Kerry: investment property portfolio in China

Attributable GFA ('000 sq ft)	Beijing	Shanghai	Shenzhen	Tianjin	Fuzhou	Total
Apartment	277	774	-	-	-	1,051
Commercial	98	1,099	212	428	64	1,901
Office	711	1,503	1,552	-	-	3,766
Total	**1,086**	**3,376**	**1,764**	**428**	**64**	**6,718**
% share	16%	50%	26%	6%	1%	100%

Source: Company

Kerry: major development landbank in HK

	Project	Location	Type	Stage of completion	Expected Completion	Attri. interest	Share of buildable GFA (sq ft)
1	The Bloomsway	So Kwun Wat	Residential	Superstructure work in progress	4Q16	100%	939,600
2	Shan Kwong Road Project	Happy Valley	Residential	Superstructure work in progress	4Q16	100%	81,217
3	Mantin Heights	Ho Man Tin	Residential	Superstructure work in progress	1Q17	100%	1,142,168
4	Beacon Hill Project	Beacon Hill	Residential	Foundation work in progress	2Q18	100%	116,380
5	Hing Hon Road Project	Sai Ying Pun	Residential	Schematic design in progress	3Q19	71%	47,962
6	Nam Van Project	Macau	Residential	Schematic design in progress	2Q20	100%	397,190
	Total						**2,724,517**

Source: Company

Kerry: major development landbank in China

	Project	Location	Type	Stage of completion	Expected Completion	Attri. interest	Attri. GFA (sq ft)
1	Qinhuangdao Habitat Ph I Tower 3, Ph 2 and 3	Qinhuangdao	R / C	Ph I - Interior decoration work in progress	Phase I - 1H16	60%	2,360,409
2	Yingkou Hyades Residence and Hotel Development	Yingkou	R / H / C	Ph I - External work, interior decoration & mechanical & engineering work in progress	Phase I - In phases from 2016	65%	2,796,905
3	Putian Arcadia Court West District and Hotel Development	Putian	R / H / C	Ph I - Residential: External work, mechanical & engineering work in progress	Phase I - In phases from 2016	60%	1,608,987
4	Changsha Xiangjiang Arcadia Court Phase II and III	Changsha	R / C	Ph II - Interior decoration, external work, mechanical & engineering work in progress, Ph III - Schematic design in progress	In phases between 2016 & 2019	100%	2,313,076
5	Nanjing Residential Development	Nanjing	R	External work in progress	2017	100%	1,028,898
6	The Berylville, Ningbo Ph 2	Ningbo	R	Piling work in progress	2017	50%	314,293
7	Hangzhou Zhijiang Castalia Court	Hangzhou	R / C	Ph I - Interior decoration work in progress, Ph II - Structural work in progress	In phases from 2017	100%	2,482,858
8	The Metropolis - Arcadia Court Phase II & III	Chengdu	R / C	Ph II - Mechanical & engineering work in progress, Ph III - Schematic design in progress	In phases from 2017	55%	2,640,350
	Total						**15,545,776**

Source: Company
Note: R = residential, O = office, C = commercial, H = hotel

Hong Kong | Financials | 25 May 2016

Daiwa Capital Markets

New World Development (17 HK)

Target price: **n.a.**

Share price (23 May): **HKD7.11** | Up/downside: **-**

5 4 3 2 1

No Rating

Making attempts to refocus

- Has been trying to re-focus on Hong Kong property
- Asset sale to Evergrande to help fund privatisation of NWCL
- Execution related to the redevelopment of New World Centre is key

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Background: New World Development used to be one of the largest property developers in China but its development since the late 1990s has been affected by over-diversification into new areas (such as telecom, infrastructure, China etc.), which has raised its debt and reduced its profitability. In recent years, however, the group has tried to refocus on Hong Kong property and has achieved a steady rise in its residential contract sales in Hong Kong. It, too, has sold some China projects to Evergrande and also launched the second privatisation offer for New World China Land (NWCL) in January 2016.

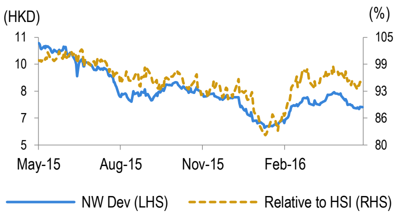
Highlights: *Sale of China projects to Evergrande could help it monetise a significant portion of its China assets,* as management expects the deal to raise HKD25.1bn upon full payment by 2018. This deal would also allow the group to concentrate on the major cities in China, as its exposure to many lower-tier cities in China would be cleared after the asset disposals.

The privatisation of NWCL would basically be funded by the asset sale to Evergrande, as the amount required, HKD21.3bn based on its offer price of HKD7.80, could be more or less covered by the sales proceeds obtained from Evergrande. That said, accounting wise, there is some impact from the timing difference in the completion of these 2 deals, as the cash required for privatising NWCL might need to be paid in 2H16, while the cash paid by Evergrande would be fully received only by 2018. In the meantime, the group would also be exposed to the risk associated with the delay or cancellation of payments from Evergrande. That said, if NWCL is privatised, New World Development would be able to receive all the cash NWCL realised from its rental properties and property sales.

New World Centre redevelopment would be its most important project in Hong Kong in the next few years. This project has a total GFA of 2.95m sq ft and is scheduled to be completed from 2017 onwards. It has signed up Mizuho as an anchor tenant for its office tower. As regards the mall portion of this development, it has not yet started official pre-leasing, and its positioning and leasing progress remain to be seen. How well the execution of this mall proceeds would be crucial to its longer-term earnings and NAV prospects. In the meantime, New World also has over 20m sq ft of farmland in Hong Kong which is another parameter in the future prospects for its earnings and NAV.

Valuation: New World Development's reported end-2015 BVPS was HKD19.2 and it is now trading at a PBR of 0.37x. This compares with its historical average PBR of 0.7x.

Share price performance



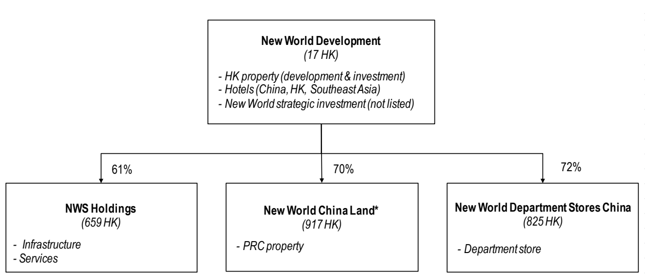
12-month range	5.95-10.68
Market cap (USDbn)	8.59
3m avg daily turnover (USDm)	15.58

Source: FactSet, Daiwa forecasts

See important disclosures, including any required research certifications, beginning on page 175

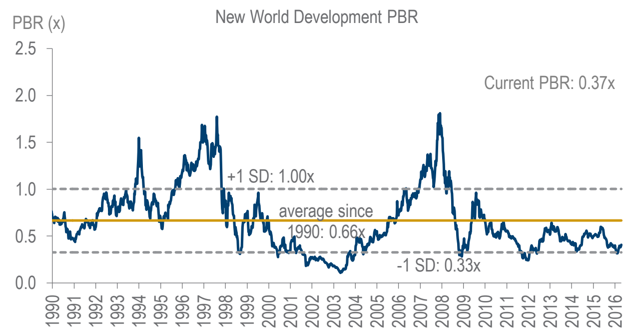
Company

New World group: corporate structure



Source: Company
Note: *privatisation of New World China Land is expected to be completed in 2016

New World Development: PBR



Source: Company, Datastream, Daiwa

New World Development: landbank in Hong Kong

District	Attributable GFA (sq ft)
Central and Western District	175,346
Eastern District	1,053,888
Yau Tsim Mong District and Kwun Tong District	3,605,269
Tsuen Wan District, Yuen Long District and Tuen Mun District	786,180
Sha Tin District and Sai Kung District	3,220,188
Others	107,920
Total	**8,948,791**

Source: Company

New World Development: agricultural landbank by location

District	Attributable land area (sq ft)
Yuen Long District	11,949,418
Fanling District	1,987,460
Sha Tin District and Tai Po District	1,945,090
Sai Kung District	1,160,529
T uen Mun District	28,260
Total	**17,070,757**

Source: Company

New World Development: major investment properties in Hong Kong

Completed properties	Location	Attributable GFA (sq ft)
Manning House, Central	Central	110,040
New World Tower, Central	Central	640,135
Shun Tak Centre, Shopping Arcade	Sheung Wan	96,451
HKCEC Shopping Arcade	Wan Chai	87,999
Grand Hyatt Hong Kong	Wan Chai	167,977
Renaissance Harbour View Hotel	Wan Chai	174,246
Pearl City	Causeway Bay	46,158
Eight Kwai Fong	Happy Valley	57,965
2 MacDonnell Road	Mid-levels	116,954
Methodist House	Wan Chai	40,405
Telford Plaza	Kowloon Bay	335,960
K11	Tsim Sha Tsui	264,552
Hyatt Regency Hong Kong	Tsim Sha Tsui	88,921
Pentahotel Hong Kong	San Po Kong	285,601
Koho	Kwun Tong	204,514
ATL Logistic Centre	Kwai Chung	3,190,518
NWS Kwai Chung Logistics Centre	Kwai Chung	562,120
Discovery Park Shopping Centre	Tsuen Wan	466,400
PopCorn II	Tseung Kwan O	88,011
Hyatt Regency Hong Kong	Sha Tin	538,000
Citygate	Tung Chung	131,800
Novotel Citygate Hong Kong	Tung Chung	47,352
		7,742,079
Under development		
New World Centre redevelopment	Tsim Sha Tsui	2,951,444
704-730 King's Road, North Point	North Point	438,754
TCTL 11, Tung Chung	Tung Chung	107,920
12 Salisbury Road (formerly SOGO Tsimshatsui)	Tsim Sha Tsui	141,331
		3,639,449

Source: Company

Wheelock & Company (20 HK)

Target price: **n.a.**

Share price (23 May): **HKD32.95** | Up/downside: -

5 4 3 2 1

No Rating

Continuing to build up landbank and credentials?

- Focusing on property in 2nd attempt to transform into a conglomerate
- Already an emerging force in the HK property development business
- Continues to raise its stake in Wharf, now worth HKD37.0/share

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Background: Wheelock & Company, founded in 1857, is one of the 4 largest British conglomerates in Hong Kong. It was acquired by the YK Pao family in the 1980s and subsequently became the holding company of Wharf (4 HK, HKD41.35, Buy [1]) after several re-organisations. It currently has a 60.0% stake in Wharf and a 75.8% stake in Wheelock Properties (Singapore) (WP SP, SGD1.45, not rated).

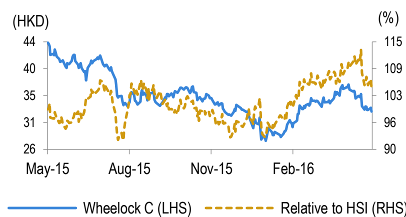
Highlights: 2nd attempt at transformation is focused on property development. Wheelock made its first attempt to transform into an actively managed conglomerate in the early 1990s, by investing in a range of businesses, including retail, beverages, investment banking and property. It sold off most of these businesses after the Asia financial turmoil in 1997 and reverted to being an investment holding company. However, in 2011, it embarked on a second attempt to transform, choosing this time to focus primarily on the property development business, mainly in Hong Kong.

An emerging force in property development in Hong Kong. The group started building up its landbank in 2011, and has sold various residential and office projects, such as One Island South, One Bay East, The Austin, etc. We note that in terms of landbank, it is now a major player in several areas like Tseung Kwan O and Kowloon East. In the developing Grade-A offices for sale segment, Wheelock has become one of the largest players, having raised over HKD10bn from the sale of One Bay East and having sold a tower of One Harbour Gate to China Life in Nov 2015 for HKD5.85bn.

Swapped physical assets for Wharf shares, effectively capitalising on the 'Hong Kong discount'. In August 2014, Wheelock sold Crawford House to Wharf for HKD5.8bn, after having bought about HKD5bn worth of Wharf shares in the open market. In March 2016, Wheelock sold Wheelock House in Central to Wharf for HKD5bn, after having bought some HKD3.3bn worth of Wharf shares in the open market. Effectively, this resembles swapping physical property assets at market value into Wharf shares, which are trading at a deep discount to Wharf's underlying NAV. This bears some resemblance to what the Link REIT has been doing since 2014 in terms of asset disposals and share buybacks, in that both are ways to capitalise on the 'Hong Kong discount'.

Valuation: Based on Wharf's current share price of HKD41.35, Wheelock's 60.0% stake in Wharf is worth HKD75bn or HKD37.0/share vs. Wheelock's current share price of HKD32.95. The market value of its stake in Wheelock Properties (Singapore) is HKD3.6/share. Wheelock's shares are trading currently at a PBR of 0.3x based on the end-2015 reported BVPS of HKD99.3, compared with a past 15-year average PBR of 0.6x.

Share price performance



12-month range	27.45-43.90
Market cap (USDbn)	8.61
3m avg daily turnover (USDm)	5.00

Source: FactSet, Daiwa forecasts

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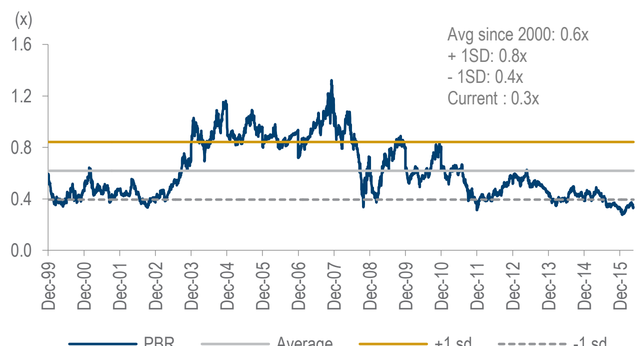
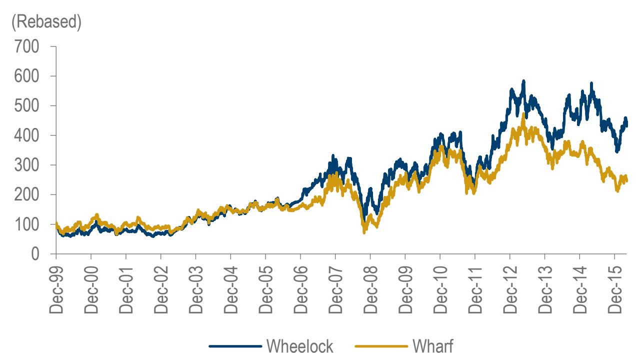
Wheelock: PBR since 2000



Source: Bloomberg, Daiwa

Wheelock and Wharf: relative share performance since 2000



Source: Bloomberg, Daiwa

Wheelock: development property landbank in HK

Source: Company

Wheelock: focused HK development property business

Source: Company

Wheelock: land purchases since 2011

Award date	Usage	Location	Methods	No. of tender bids rec'd	Winning bidder(s)	Total GFA (sq ft)	Market estimated price (HKDm)	Market estimated price (HKD/sf)	Achieved price (HKDm)	Achieved price (HKD/sf)
11-Jul-11	Comm	Junction of Wai Yip St, Shun Yip St and Hoi Bun Rd, Kwun Tong	Tender	6	Wheelock	914,897	2,990 - 4,230	3,270 - 4,620	3,528	3,856
4-Aug-11	Comm	Junction of Hung Luen Rd and Kin Wan St, Hunghom	Tender	5	Wheelock	589,996	3,371 - 5,015	5,500 - 8,500	4,028	6,827
12-Jan-12	Resi	Area 66B2, Tseung Kwan O	Tender	8	Wheelock	489,011	1,538 - 2,016	3,150 - 4,130	1,860	3,804
13-Dec-12	Resi	Area 68A1, Tseung Kwan O	Tender	6	Wheelock	429,731	1,934 - 2,119	4,500 - 4,930	1,968	4,580
30-Jan-13	Resi	Junction of So Kwun Wat Rd and Kwun Chui Rd, Tuen Mun	Tender	9	Wheelock	376,891	1,130 - 1,500	3,000 - 4,000	1,388	3,683
10-Apr-13	Resi	Area 65C1, Tseung Kwan O	Tender	9	Wheelock	572,465	2,160 - 2,850	3,800 - 5,000	2,449	4,301
14-Jun-13	Resi	Junction of Fat Kwong St and Sheung Foo St, Homantin	Tender	13	Wheelock	387,764	3,490 - 4,381	9,000 - 11,300	3,829	9,875
10-Jul-13	Resi	Area 68B2, Tseung Kwan O	Tender	7	Wheelock	855,964	3,940 - 4,110	4,600 - 4,800	3,670	4,288
28-May-14	Resi	Kai Tak Area 1H Site 3, Kai Tak	Tender	12	Wheelock	413,015	2,270 - 2,480	5,500 - 6,000	2,520	6,101
26-Nov-14	Resi	LOHAS Park Package 5 (MTRC), Tseung Kwan O	Tender	6	Wheelock	1,101,545	na	na	2,064*	1,874*
5-Jun-15	Resi / Comm	LOHAS Park Package 7 (MTRC), Tseung Kwan O	Tender	7	Wheelock (resi portion only)	1,235,277 (resi:756,279 / comm: 478,998)	na	na	3,890* (resi: 1,450 / comm: 2,440)	3,147* (resi: 1,917 / comm: 5,094)
31-Dec-15	Resi	LOHAS Park Package 9 (MTRC), Tseung Kwan O	Tender	6	Wheelock	1,120,630	na	na	2,852*	2,545*

Source: Hong Kong Economic Times, Lands Department, Daiwa
Note: * land premium set

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Source: Daiwa

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