Daiwa Capital Markets

Does Swire Properties have its own "secret sauce"?

Q&A addressing the market's continuing misconceptions about Swire Properties and its special business model

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Special Report

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		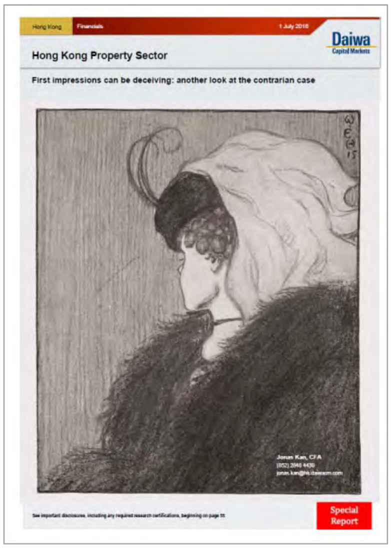

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Does Swire Properties have its own “secret sauce”?

Our cover image features an itamae (板前), a cook in a Japanese kitchen, or a chef in a large, typically high-end restaurant. According to Wikipedia, Dave Lowry, in his book *The Connoisseur's Guide to Sushi: Everything You Need to Know About Sushi*, describes 4 criteria by which to judge a good itamae: 1) how he (or she) handles the food, 2) how he handles his food utensils, 3) how he treats his clients, and 4) how he behaves, moves and works. It is no easy feat becoming an itamae, as the training can take from 2 to 20 years.

One of the responsibilities of an itamae on his or her way to becoming a master itamae is the preparation of sushi rice in accordance with the restaurant’s very own recipe of rice, salt and rice vinegar. And this “secret sauce” is crucial to the end-product...

This report builds on our 22 May 2014 initiation report on Swire Properties (Initiation: a large “nurturing reward” awaits) in which we argued there was a so-called nurturing reward awaiting the group stemming from its special business model. This model has worked well in transforming 2 major locations in Hong Kong, and as a result the company has applied it to various locations in China and Miami.

We believe the locations that are being transformed by Swire Properties have become “stronger and more relevant” commercial hubs since our May 2014 report was published. But it seems these developments are not yet well-understood or recognised by the global capital markets, which tend to classify stocks in accordance to perceptions related to their identity and their most important asset classes.

While such an orientation is understandable, we think the market has unduly penalised Swire Properties for the challenges faced by its Pacific Place mall in Hong Kong, which has led to the market overlooking what the company has achieved thus far — and we think what it is on course to achieve in the future — in the Hong Kong office and China commercial property sectors.

This report also follows on from our 25 May sector report (It’s time to be more greedy than fearful) and 1 July thought piece (First impressions can be deceiving: another look at the contrarian case) in which we argued that up to USD100bn in investment value could be unlocked if perceptions about the Hong Kong family business groups and property companies change over time.

We reiterate our view that, with its special model in global property, Swire Properties deserves to be more broadly recognised in the global property market, and that, over time, this enhanced recognition will show in its valuation. As such, we see the stock as an attractive vehicle through which to play one of our central themes: the narrowing of “the valuation anomaly of Hong Kong property stocks.”

Jonas Kan, CFA, Head of Hong Kong and China Property

Question 1

Run-of-the-mill property company in Asia — or one with its own “secret sauce”?

Q1: Does Swire Properties have a "secret sauce"?

"It is just not necessary to do extraordinary things to get extraordinary results."

- Warren Buffett

"Compound interest is the eighth wonder of the world. He who understands it, earns it...he who doesn't…pays it..."

- Albert Einstein

The business models of property companies in Hong Kong, and probably in Asia, are different from those adopted in the developed market, which we believe is one of the reasons Hong Kong property stocks have traded at discounted valuations to their global peers for many years, and the reason few property companies in Asia are seen as parallels to the premier names in global property, such as Simon Property, Boston Properties, and Unibal Rodamco (see our May 2016 sector report: *It's time to be more greedy than fearful*, and our July 2016 thought piece, *First impressions can be deceiving: another look at the contrarian case*).

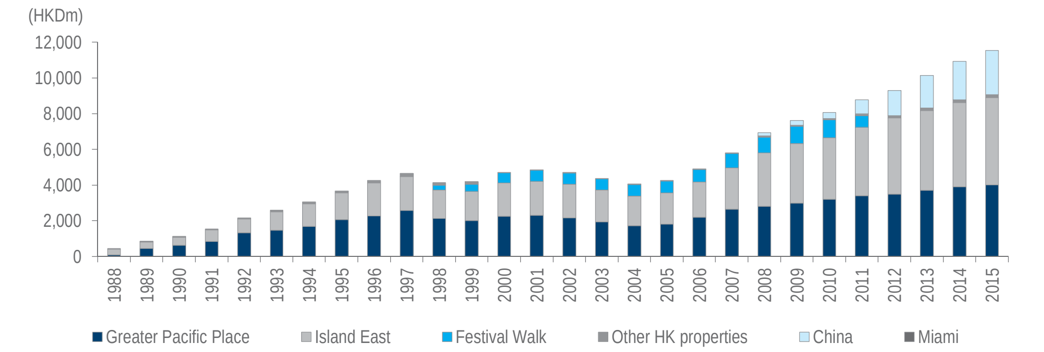
We concur with market observers that the property space in Asia comprises mainly asset owners and asset traders, and that there are still few savvy and professional managers of property assets in this part of the world. As a matter of fact, most major property companies in Asia remain family-owned and tend to focus more on building and accumulating prime property assets for posterity, and may not pay as much attention to the priorities and expectations of institutional investors as do their Western counterparts and the REITs.

The Swire Group is a 200-year-old company. All along, the group has been known for its conservatism and focus on a few businesses, almost all of which are traditional industries, and some of which date back 200 years. Against this background, we think it is understandable that some investors might perceive Swire Properties as just another run-of-the mill property company in Asia.

However, we believe there are 2 aspects that differentiate Swire Properties from many other property companies in Asia: 1) the high return of its property business, and 2) its ability to create "gold mines" or locations that can become "strong and relevant".

First, is the company's property business has organically generated a high return over the years for its shareholders. On our estimates, the property assets currently owned by Swire Properties have a market value of USD30bn, over 100x the capital the Swire Group put into its property business when Swire Properties was first started in 1972.

Swire Properties: gross rental income from key locations



Source: Company, Daiwa

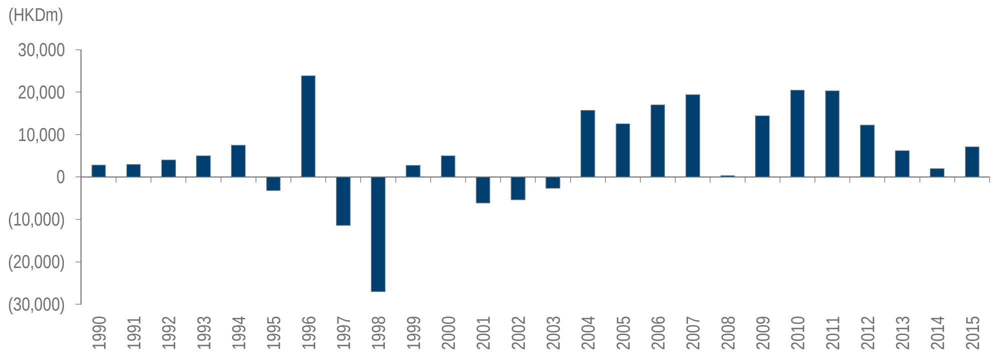
But we do not think the rate of growth in value of its property assets is the most impressive aspect of the returns generated by Swire Properties. Rather, we believe it is that the company has managed to build up such a portfolio of prime commercial property assets through mainly start-up capital (which has been modest) and retained earnings – Swire Pacific (parent company of Swire Properties) has not raised any equity capital in at least the past four decades, and all along, has never been highly geared.

In other words, Swire Properties has built up commercial property assets whose value is not far from those of any major property company in the world, without having made use of any external equity capital, and without having been very highly geared during any particular period. Moreover, its achievements have rivalled those of the most successful property companies in the industry even though it has utilised a much lower amount of equity capital and never having taken on significant leverage. It therefore follows that its core business has generated impressive sustainable returns, and we believe this aspect has not been well understood by the market.

However, we believe the returns of Swire Properties' business model have been masked by Hong Kong Accounting standards, which require investment properties to be revalued every 6 months. This has had the effect of consistently boosting Swire's equity base, and hence its accounting-based ROE has understated the true ROE of the business.

Of the group's HKD216bn in shareholders' funds in 2015, we estimate that the bulk was revaluation gains accumulated over the years. The cash cost related to Swire Properties' investment into its 2 key locations in Hong Kong – Pacific Place and Taikoo Place – is below HKD50bn, on our estimates, and yet they generated over HKD8bn in gross rental income in 2015.

Swire Properties: property revaluation gains over the years



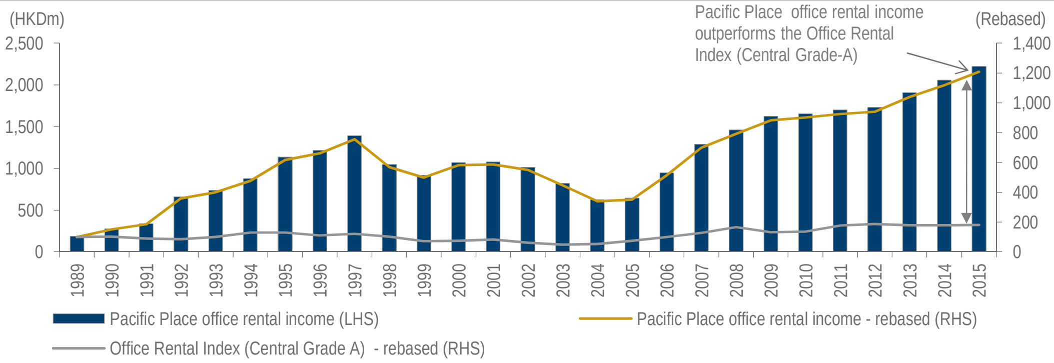
Source: Company

Note that a large part of Swire Properties' Taikoo Place portfolio (especially the westward expansion of it) came from the redevelopment of old buildings which it had acquired at market prices over the previous 10-20 years, and this expansion probably diluted the return profile of the portfolio.

We estimate that the total cash cost investment for Swire Properties' Pacific Place portfolio is under HKD4bn excluding the hotels. However, the portfolio generated over HKD4bn in gross rents in 2015, and we estimate that the yield on cost generated by Pacific Place was well over 80% per year.

In this light, what Swire Properties has been doing over the years is reinvest the super-high returns generated by the initial portfolio of Pacific Place into building up Taikoo Place as well as its China portfolio (about HKD36bn invested so far, we estimate) and to a lesser extent Miami (about HKD6bn invested so far, we estimate).

Swire Properties: rental income from Pacific Place offices vs. Central grade-A offices



Source: CEIC, Company, Daiwa

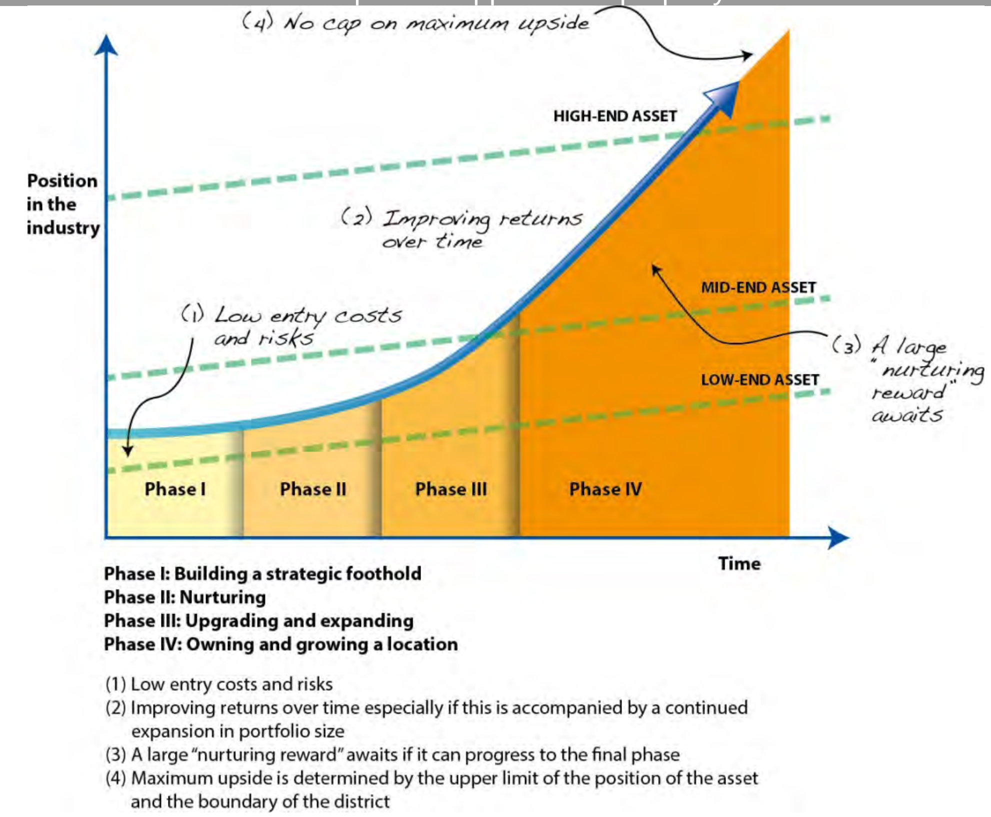
On our estimates, the current achieved return for Taikoo Place cannot yet match that of Pacific Place, as current achieved rents in the district surrounding Taikoo Place are still considerably below those of Pacific Place. Moreover, the westward expansion of its Taikoo Place portfolio came from the acquisition of old buildings for which it had to pay prevailing mid-1990s market prices when these parcels of land were acquired (versus the mid-1980s for Pacific Place when prices were lower). That said, we estimate that the current yield on cost for Taikoo Place is still well over 10%, and believe that among all the commercial hubs in Hong Kong, Taikoo Place offers the biggest potential for a rental uplift, and that the whole area is on the threshold of a major leap forward.

Note that all the benefits from a continued upgrading of the area – and the associated uplift in rents – would flow through to Swire Properties’ 10m sq ft portfolio there at a limited incremental cost. The lease term for Taikoo Place is 999 years and we think it is not inconceivable that one day, the current yield on cost of Taikoo Place could catch up with Pacific Place’s. By that time, Swire Properties could be sitting on 2 gold mines with over 15m sq ft GFA, generating higher and higher returns every day.

Furthermore, we would advise investors not to lose sight of the fact that: 1) offices make up the largest component of Pacific Place and rents for and scale of the office space appear to be going from strength to strength, 2) the situation faced by Pacific Place mall is more subtle and complex than it appears and its problems may not be unsolvable, in our view, 3) the returns generated by Taikoo Place look set to accelerate in the years to come, and 4) the company’s China investments also appear to have finally entered the beginning of a harvesting period.

And so to the second feature of the company’s property business: its ability to create “gold mines” or locations that can become “strong and relevant” (to use property jargon). In global property, there are some companies that have inherited locations that were strong and relevant to start with and demonstrated a capability to keep them strong and relevant for a long time. However, there are a few others that have adopted Swire Properties’ approach of creating a strong commercial hub from scratch through meticulous nurturing over a prolonged period.

The economics of Swire Properties’ approach to property



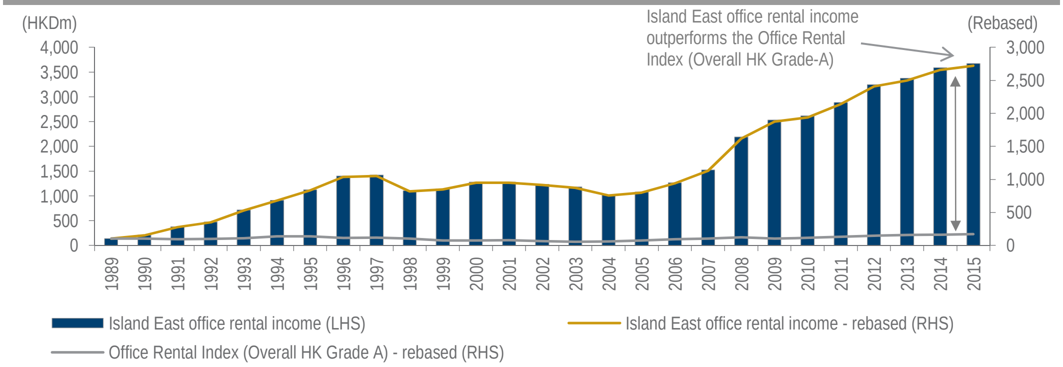
Source: Daiwa

So does Swire Properties have a “secret sauce” for the property business? We believe it has: its large-scale mixed developments. While Swire Properties may not be the first property company in the world to own and operate large-scale integrated property projects encompassing office, retail, hotel and other usages, we believe it is one of the world’s pioneers in terms of purposely amalgamating different property segments, designing them in such a way as to foster interaction and cross-fertilisation among them, nurturing them carefully and meticulously over time, with the ultimate vision of turning them into a kind of “magnet” that can gather economic force to drive the transformation of the whole location over time.

Such a business model, while requiring a large capital commitment, patience and meticulous work during the nurturing period, can pay off handsomely over time, as the benefits of the continuous upgrading of the location flows through a large – and ever-expanding – portfolio at a limited incremental cost.

While this situation may not be obvious to the stock market, a closer inspection reveals that the office rental income generated by Pacific Place and Taikoo Place has significantly outperformed the Hong Kong office sector overall since they were completed in around 1990. We attribute this outperformance to the continuous rerating of these locations and the company’s continuous expansion of its portfolio, and believe these factors have formed a kind of virtuous cycle.

Swire Properties: rental income from Island East offices vs. Hong Kong Grade-A offices



Source: CEIC, Company, Daiwa

Another important development is Swire Properties’ growing credentials in terms of being able to apply its proven franchise in Hong Kong to other cities. We believe its China investments show promise, in that they seem to have succeeded in finding a way to attract genuine consumers to come to the malls to shop, and this appears pretty much the case for all the cities in which it currently operates in China. Meanwhile, the Brickell City project in Miami is also showing promise.

We see Swire Properties as a property company with a differentiated, one might say even proprietary, way of running its property business, and argue this way of operating has historically generated impressive returns to shareholders. Moreover, we see Pacific Place and Taikoo Place as having entered their most rewarding phase, while its China and Miami portfolios are on a promising track. As such, we contend that Swire Properties deserves a place in global property, and should be recognised and priced as such eventually. With none of these many positive attributes appearing to have been priced in to its shares at the moment, we think now is a good opportunity for fundamental-value-oriented investors to buy Swire Properties shares for the long term.

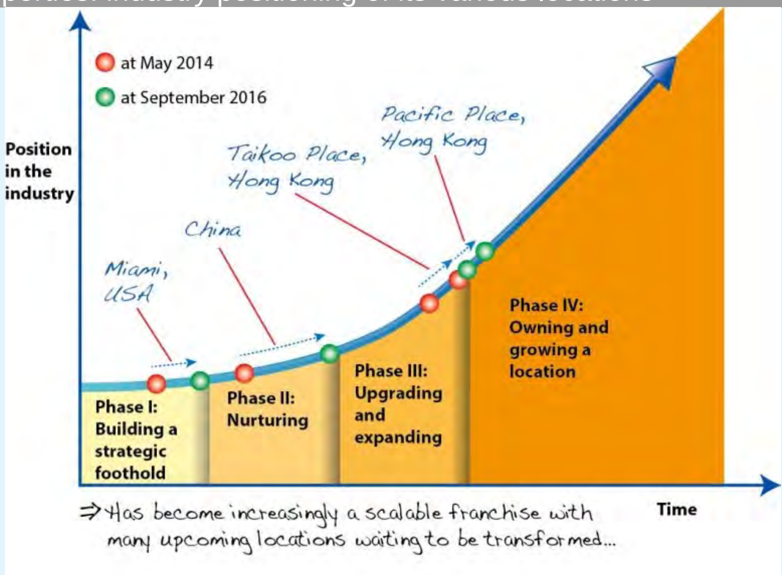
Extract: The "nurturing reward" embedded in Swire Properties' special business model

In our 22 May 2014 initiation report on Swire Properties, we argued there was a large "nurturing reward" awaiting the company stemming from its special approach to the property business, which involves investing in key locations in order to transform them over a period of decades.

Essentially, we think Swire Properties' business model is about the creation of locations — it usually starts with securing a large strategic site in a location that is not yet prominent, and then works on meticulously transforming the area into a stronger and more relevant location for commercial properties. The caveat of this business model is that it requires significant management efforts and commitment in the initial years, but the merits of the approach continue to improve over time, with the assets it has been nurturing gradually becoming able to generate large and improving free cash flow. Having a large and low-cost income-producing property portfolio in upcoming locations, meanwhile, puts Swire Properties in an advantageous position in terms of participating in the future growth and expansion of that location.

We see this type of business model as long-term and back-end loaded, whereby the biggest portion of what we call the "nurturing reward" kicks in most strongly in the final phase. The benefits come from having a large and expanding portfolio in some increasingly strong and relevant locations where it dominates, as the following diagram illustrates.

Swire Properties: industry positioning of its various locations



Source: Daiwa

However, once the basic ingredients and structure have been put in place and start driving a continuous upgrading of the property and location, the "nurturing reward" should start to become evident, resulting in the property asset showing a more resilient performance during downcycles and its rental and capital values being able to perform better during upcycles. As and when the portfolio is able to make another major leap forward, then the rental and capital values of the portfolio should do likewise.

Shown above is our take on the position of the 4 key locations (Pacific Place Hong Kong, Island East Hong Kong, China and Miami [US]) that Swire Properties has been nurturing.

Question 2

Has the market unduly penalised Swire Properties because of the mall at Pacific Place?

Q2: Has the market unduly penalised Swire Properties because of Pacific Place?

“... the difficulty lies, not in the new ideas, but in escaping from the old ones which, for those brought up as most of us have been, ramify into every corner of our minds.”

\- John Maynard Keynes

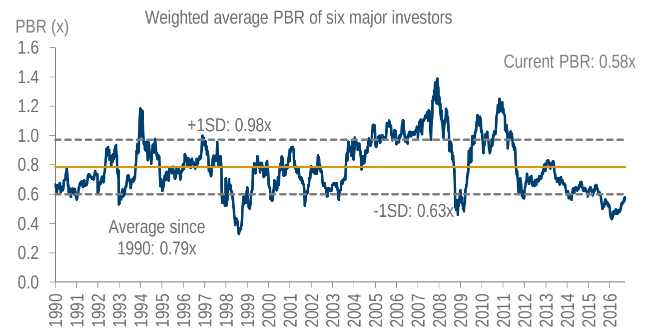
"*It is not a case of choosing those [faces] that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe, who practice the fourth, fifth and higher degrees.*"

\- John Maynard Keynes

In our opinion, the listing of Swire Properties in January 2012 marked an important addition to the universe of global property stocks. However, it appears that this event has not been recognised as such by the market, although 5 years have passed since its listing.

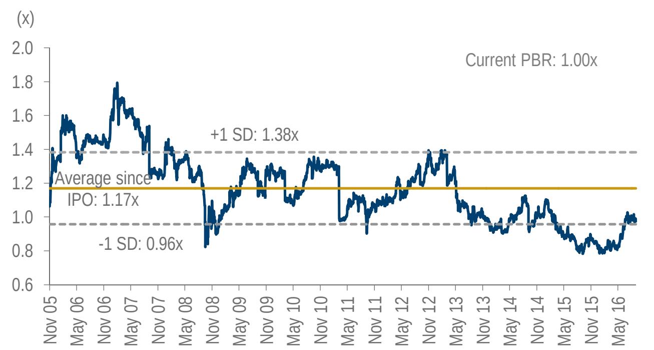
We see reasons for this lack of recognition, not least because the entire basket of Hong Kong property stocks has not been seen and priced as core stocks in the universe of global property, not to mention in the universe of global stocks. In this connection, it seems ironic that it is Link REIT, which owns far less prime retail property assets than the major property companies, which has become the first and so far only Hong Kong property stock to be priced and valued like a global property stock on a sustained basis.

Major Hong Kong property investors: PBR



Source: Companies, Datastream, Daiwa

Link REIT: PBR



Source: Company, Bloomberg, Daiwa

That said, in our view, Swire Properties’ case cannot be entirely attributed to the so-called anomaly in valuations of Hong Kong property stocks. Even within the universe of Hong Kong property stocks, our read is that Swire Properties is still not viewed by many as a core stock.

Lower liquidity has been the most oft-cited reason (Swire Properties was listed in January 2012 by introduction, which did not involve the issuance of new shares. Its parent company, Swire Pacific, currently owns 82% of Swire Properties, thus making its free float only about 18%). However, our view is that this is not the only reason because even if Swire Properties’ free float were to substantially increase, we would not expect the aforementioned situation to rapidly change.

In our opinion, a deeper issue is that Swire Properties faces some misperceptions — or even identity confusion — which we seek to address in this thought piece. In our view, one issue involved in the pricing and valuation of Swire Properties shares is that it does not seem to readily fit into many of the typical templates or classification methods investors use to price stocks. Our observation is that there is a tendency for investors to classify stocks in accordance with their perceived exposure to certain business segments, and these stocks tend to be priced in accordance with changing investor opinions and expectations of these segments.

As such, in the stock market, it is common for stocks to be priced as a kind of proxy for what are perceived to be the most important drivers of the business. Accordingly, we believe Wharf is seen as a proxy for Hong Kong retail overall (or just 2 malls), Hongkong Land as a proxy for Hong Kong office, Sino Land as a proxy for Hong Kong residential, Hang Lung Properties as a proxy for China high-end retail, while SHK Properties is priced as a proxy for Hong Kong property overall.

Probably because many investors seem to have an entrenched perception to associate Swire Properties with Pacific Place mall, the stock is viewed as a company with significant exposure to high-end malls, and hence the difficulties faced by Pacific Place mall have weighed on the perceived attractiveness and prospects of Swire Properties shares in recent years.

While such a view in the stock market is natural and understandable, it could also result in Swire Properties receiving less investor recognition than its corporate fundamentals and competitive position in the Hong Kong China property space warrant, as it does not seem to have a clear-cut and attractive identity in the stock market. Indeed, we believe that many common perceptions about Swire Properties (listed below) in the stock market may have led to its shares being unduly penalised.

Identity confusion faced by Swire Properties as a stock?

Common perception	Alternative interpretation
Pacific Place mall is a major drag	The importance of this mall has declined significantly versus the past, with it now accounting for only about 12% of Swire Properties' total gross rental income
Pacific Place is mainly about its mall	Pacific Place has evolved into a more office-centric portfolio and all the other components of Pacific Place are doing well
Pacific Place mall is on the decline and the trend looks irreversible	Probably too early to draw a conclusion on this. Concerted efforts are being made to recalibrate the Pacific Place mall and there are also other factors which are working in Pacific Place's favour as a location.
The Hong Kong office sector is at a cyclical peak, and will follow retail and residential to correct sooner or later.	The HK office sector is actually the leading property segment in this cycle. The cyclical adjustment in the HK office market is probably already over.
Kowloon East will pose a major competitive threat to Taikoo Place in Island East	The impact of Kowloon East is probably multi-dimension. We believe it will strengthen the HK office market overall and other districts may well benefit from it. The current contour of office rents in different districts looks reasonable and sustainable.
There are other stocks with which to play the HK office market and Swire Properties doesn't fit well into either the Central or decentralisation theme.	Swire Properties' whole portfolio looks well prepared for the challenges. If one sees through the complexity and dynamics of the HK office sector, one would likely find that the company is the best-positioned among HK office landlords
Swire Properties is a late-comer to China and it is hard for foreigners to succeed in China property	KPIs from its malls suggest that its malls are progressing on track and Swire Properties has good credentials to be one of the major players in China
Brickell is an ignorable investment	Swire can well afford the expertise and capital to roll out this project, where some would regard it as a once-in-a-lifetime opportunity to secure a great site to ride on Miami's future potential as an international financial hub for Latin America.

Source: Daiwa

From our perspective, Swire Properties' business model essentially entails using large-scale mixed developments to nurture, create and transform locations, making what previously would have been seen by many as ordinary locations into ones that are "strong and relevant" (to use jargon in the property space) and become increasingly so over time. It has successfully built 2 "gold mines" in Hong Kong (both of which look set to enter their most lucrative phase in the next few years), and it is showing promise in creating more gold mines in China and Miami.

However, such a theme is probably too "Swire-specific" to quickly achieve "critical mass" in terms of investor interest. Meanwhile, given that Swire Properties' business model essentially revolves around large-scale mixed developments, by definition it is hard to categorise Swire Properties under any specific segment. It is the largest Grade-A office landlord in Hong Kong, but its office portfolio has both central and decentralised elements and hence does not fit entirely into the theme of the dominance of Central or that of the decentralisation of the Grade-A office market. In the meantime, it also owns retail, and has mixed developments in various cities in China. Moreover, its Miami project is one of the largest-scale mixed developments under development in the US currently.

As such, we could say that there is an inherent mismatch between the businesses of Swire Properties and the typical way the stock market prices and values the stock. Such a mismatch has pros and cons. On the negative side, there is a tendency for the shares of Swire Properties to be under-priced by the stock market as it is not seen as "the play" on any particular property segment, and its shares cannot get a full ride out of any particular property segment seen as "the fashion of the day" by the stock market.

That said, being overlooked in such a way due to the stock market's method of pricing such stocks could also present an opportunity for investors, especially those who are more value and long-term oriented and take the view that, over time, the equity-market valuation of a company will eventually reflect the bottom-up valuation of its business.

We contend that there are certain companies in the world that are priced based on yardsticks specifically relevant to them. We see the chance that Swire Properties being priced differently over time if the global investing world gathers sufficient knowledge and becomes confident that the company has competently followed a “one-of-a-kind” business model, and has shown an ability to generate impressive returns for shareholders and a commitment to share such returns with all shareholders in the years to come.

We see a case for Swire Properties stock to be priced differently from what it has been thus far, and for the shares to be seen and priced more like those of a global property stock. Whether such a change will occur is predicated on whether the market thinks more deeply about various issues, some of which we tackle in this thought piece.

Among the various perceptions/overhangs which have penalised Swire Properties stock, we believe the most significant concerns the challenges faced by the Pacific Place mall.

Although many investors seem to view Pacific Place as synonymous with Swire Properties, this mall currently does not account for a significant share of its rental income or its underlying profit. So far in 2016, we estimate that the gross rental income from Pacific Place accounts for just about 12% of Swire Properties’ total gross rental income (including jointly controlled entities), and we forecast the proportion to decline to below 10% by 2018.

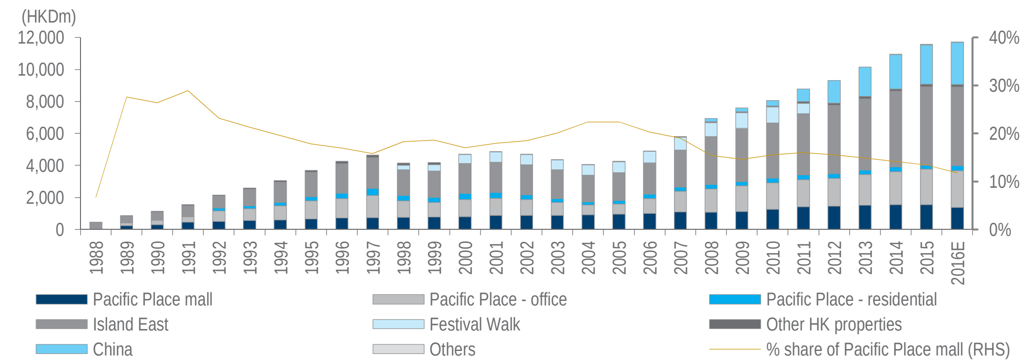
That said, we understand why the market has such a perception and think history has a part to play. In the past, the mall at Pacific Place has been seen by many as the No.1 mall in Hong Kong and the success of this mall has been widely seen as one of the main factors underpinning the success of Pacific Place. Hence, insofar as the success of the Pacific Place mall has been as a symbol of Pacific Place’s success, the headwinds faced by Pacific Place may have also be seen as a symbol of the challenges faced by Pacific Place or indeed Swire Properties as a whole.

We can see from where the perception comes from. However, we would point out that Swire Properties has long passed the days when its financial performance was highly dependent on the mall at Pacific Place. Over the years, Swire Properties has also successfully strengthened and significantly expanded the office component of Pacific Place. More importantly, it has succeeded in transforming Island East (now renamed Taikoo Place) from a back-office location into one of the premier commercial hubs in Hong Kong, and significantly expanded its office footprint there, so much so that the total rental income Swire Properties derived from its Taikoo Place portfolio is now about 20% larger than that of Pacific Place in 2016, on our estimates.

Furthermore, we estimate Swire Properties has invested about HKD36bn in China, and these investments have started paying off, and are likely to generate over HKD2.6bn in gross rental income in 2016, on our forecasts.

As shown below, the relative contribution from the Pacific Place mall has declined significantly from the early days, though it seems the stock market’s perception has yet to change to adjust for this change in business reality.

Relative contribution from Pacific Place mall to Swire Properties’ gross rental



Source: Company, Daiwa

Moreover, the situation faced by the Pacific Place mall is more subtle and complex than many realise and, depending on how well the group’s plans to recalibrate the Pacific Place mall are carried out, it is possible that the challenges faced by Pacific Place mall could be transitory and cyclical in nature.

In any case, we see Pacific Place as a whole as a property asset that is becoming “stronger and more relevant”, and believe the stock market has underestimated the full potential of Pacific Place because of some temporary difficulties faced by one segment of an entire asset whose relative importance has diminished considerably.

Question 3

Has the market misunderstood Pacific Place as a mixed development property asset?

Q3: Has the market misunderstood Pacific Place as a property asset?

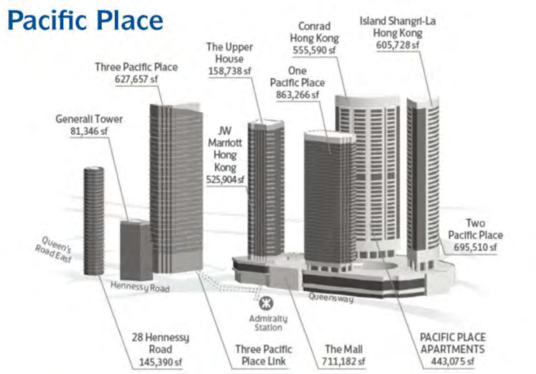
"A great investment opportunity occurs when a marvellous business encounters a one-time huge, but solvable problem."

\- Warren Buffett

That luxury retail sales in Hong Kong have been hit hard by the decline in luxury retail spending by mainland visitors is well-known — as is the decline in retail sales at the Pacific Place mall in recent years. While the Pacific Place mall used to be seen as one of the top malls in Hong Kong, in recent years a number of other malls have risen in prominence and importance, leading to the mall at Pacific Place losing market share and visitor traffic.

There is no doubt that the mall has been facing challenges and difficulties, and some may wonder whether Pacific Place as a whole will be able to do well if the mall continues to face difficulties. We would say such a scenario is possible, though had the mall become stronger, the prospects for Pacific Place would be even stronger. Meanwhile, if the other components of Pacific Place can continue to strengthen, this would have a beneficial effect on the Pacific Place mall over time. Such a scenario is one of the main strengths of a mixed development, wherein lies Swire Properties' expertise and business model.

Swire Properties: Pacific Place

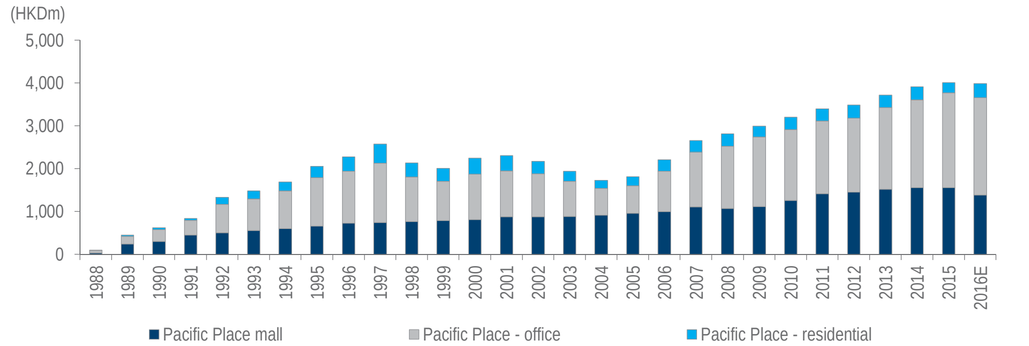


Source: Company

We think it is possible that Pacific Place as a whole will still do well if its mall continues to face difficulties because Pacific Place has long passed the time when it is highly dependent on the rental contribution from the Pacific Place mall. Under Swire Properties' business model, retail is the most important in the initial phase when the development needs to establish an identity for the location. To the extent that it can attract traffic from other areas and improve the image and perception of a location, retail is probably the most critical aspect in the initial phase of a mixed development. This is probably also why all of Swire Properties' China projects have a significant retail component currently and why we think the progress Swire Properties has made in its malls in China is a development that long-term investors should not lose sight of.

However, as time passes, and after the location has established its own identity, the relative importance of the retail component would likely diminish over time. Indeed, the experience of Pacific Place is that, while the Pacific Place mall has been critical and instrumental in transforming the image of the area, Swire Properties has recorded far more incremental income and returns from scaling-up the office portion of the development and raising its achieved rent through time.

Gross rental income generated by Pacific Place



Source: Company, Daiwa

As such, we believe the office component of Pacific Place has long overtaken retail as the main source of rental income generated by the property. Moreover, we believe the relative importance of retail to Pacific Place will diminish further over time, given that we expect a significant portion of its projects from the redevelopment of old buildings in Wanchai South will comprise office or luxury residential or serviced apartments.

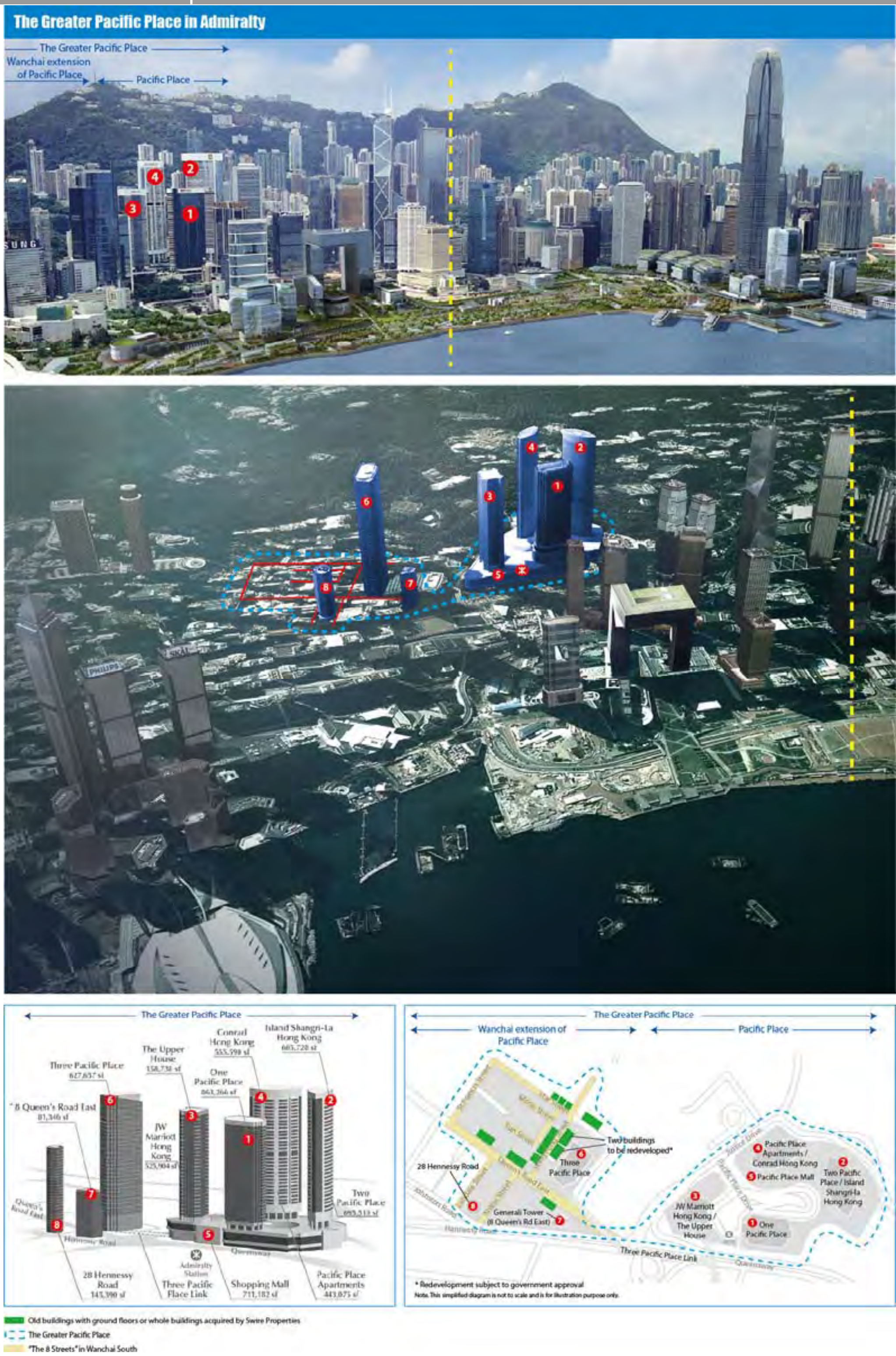
Swire Properties: evolution of its Pacific Place portfolio

Properties	Area	Year of completion	Office GFA (sq ft)	Retail GFA (sq ft)	Hotel GFA (sq ft)	Serviced apartments GFA (sq ft)	Total GFA (sq ft)	Cumulative GFA (sq ft)	No. of rooms	No. of car parks
One Pacific Place	Admiralty	1988	863,266	-	-	-	863,266	863,266	-	-
The Mall, Pacific Place	Admiralty	1988	-	711,182	-	-	711,182	1,574,448	-	470
JW Marriott HK	Admiralty	1988	-	-	515,904	-	515,904	2,090,352	602	-
Two Pacific Place	Admiralty	1990	695,510	-	-	-	695,510	2,785,862	-	-
Pacific Place apartments	Admiralty	1990	-	-	-	443,075	443,075	3,228,937	-	-
Conrad HK	Admiralty	1990	-	-	555,590	-	555,590	3,784,527	513	-
Island Shangri-La HK	Admiralty	1991	-	-	605,728	-	605,728	4,390,255	565	-
Three Pacific Place	Wanchai	2004	627,657	-	-	-	627,657	5,017,912	-	111
21-29 Wing Fung Street	Wanchai	2006	-	14,039	-	-	14,039	5,031,951	-	-
The Upper House	Admiralty	2009	-	-	158,738	-	158,738	5,190,689	117	-
Star Crest, 9 Star Street	Admiralty	2009	-	13,112	-	-	13,112	5,203,801	-	-
28 Hennessy Road	Wanchai	2012	145,390	-	-	-	145,390	5,349,191	83	-
8 Queen's Road East	Wanchai	2012	81,346	-	-	-	81,346	5,430,537	-	-
			2,413,169	**738,333**	**1,835,960**	**443,075**	**5,430,537**		**1,880**	**581**
Three Pacific Place extension?*	Wanchai									
Four and Five Pacific Place?#	Wanchai									

Source: Company, Daiwa
*Note: *Subject to government approval*
#From the redevelopment of the many sites Swire has assembled in the area over the past two decades
##Based on the full size of these hotels, which better illustrate the scale of Pacific Place. However, Swire Properties wholly owns only the Upper House and has 20% stakes in the other 3 hotels

In retrospect, one of the most important developments in the evolution of Pacific Place was Swire Properties’ ability in the mid-2000s to get the market to accept that Wanchai South was part of Pacific Place. We see this development as ground-breaking in the evolution of Pacific Place because it opened up significant scope for the expansion of its Pacific Place portfolio. It is an open secret in the property industry that Swire Properties has been acquiring old buildings in the Wanchai South area for many years, and our take is that this constitutes an important “hidden asset” of Swire Properties and has significantly strengthened the long-term potential of Pacific Place.

The eastward expansion of Pacific Place



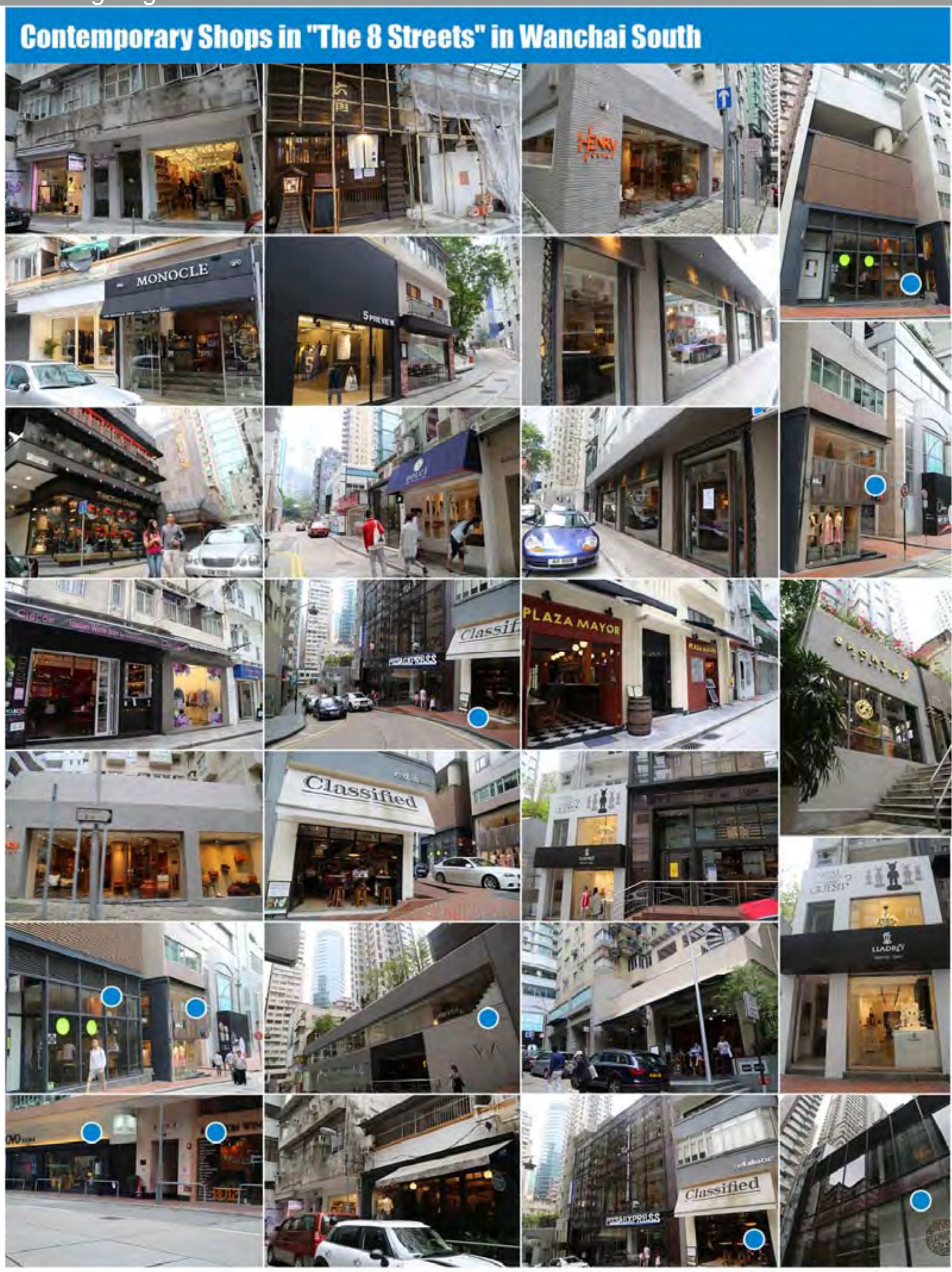
Source: Company, Google, HKSAR Government, Daiwa

In any case, a major consequence of the market’s acceptance of Three Pacific Place is that it significantly expanded the importance of office in the overall rental income of Swire Properties. Note that while some leases in Three Pacific Place were contracted at just over HKD20/sq ft during the early 2000s, its achieved rent has recently risen to over HKD90/sq ft, a more than a 3-fold rise. Essentially, Swire Properties has succeeded in realising office rents comparable to those for major buildings in Central at properties many would consider to be located in Wanchai.

In our opinion, there is still considerable room for a further revamp of Pacific Place's Wanchai South component. On the office front, its Wanchai South portfolio has been strengthened by the addition of 2 other office buildings -– Generali Tower and 28 Hennessy Road — which are different types of office products with their sub 10,000 sq ft floor plate. We see room for the continued addition of these kinds of office properties to this portfolio over time.

Moreover, we think there is also a retail dimension to this Wanchai South section of Pacific Place. Compared with 5 years ago, the shops in this area have become much more trendy and upmarket, with a kind of design flavour which raises the spectre of this area resembling Yorkdale in Toronto or even Omotesando in Tokyo over time.

What's going on in "The 8 streets" in Wanchai South



owned by Swire Properties

Source: Daiwa

Although Swire Properties has not disclosed all that it owns in the Wanchai South area in its annual reports, it has disclosed some of its holdings in the area in its IPO prospectus. We suspect that it already owns many of the ground floor shops and restaurants in the area and has continued to acquire the residential units above these shops/eateries. We consider this one of Swire Properties' important hidden asset and that the value of these assets will be revealed to the market eventually.

In all, our view is that there is considerable room for the further development of the Wanchai South area around Pacific Place. At the same time, we think that over the past few years, Pacific Place has succeeded in moving up a notch in the Hong Kong Grade A office market, in that while its achieved office rent used to be HKD10-20 lower than that of Citibank Plaza (renamed 3 Garden Road) and Exchange Square, its achieved rent is now at a premium to 3 Garden Road and is not lower than that for Exchange Square. For tenants looking for buildings beyond IFC, our view is that the Pacific Place, after the completion of its revamp in 2015, is not inferior to any of the office buildings in the core Central area.

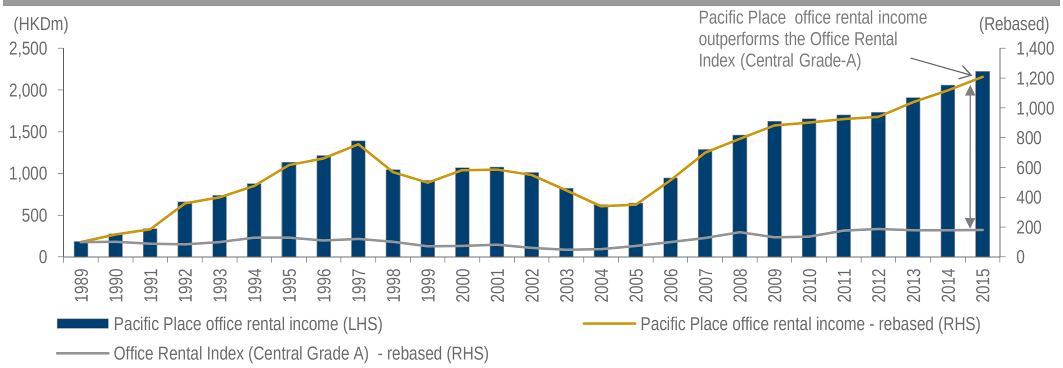
In addition, other than Wanchai South, we think there is another way to expand Swire Properties' Pacific Place portfolio. The government has stated its plan to redevelop Queensway Plaza in Admiralty into a complex of about 1m sq ft of office, retail and hotel GFA. Given Queensway Plaza's close proximity to Pacific Place, and that the retail proportion of this development could be used to link it to Pacific Place mall, if Swire Properties were to eventually win the tender (once it is officially launched), it could give the manager a lot more flexibility to fine-tune the tenant mix and bring in stronger and up-and-coming brands.

Wanchai South: new developments

Events	Year	Developers	Remarks
Completion of The Avenue	2015	Hopewell/ Sino Land/URA	A large-scale residential development with 1,300 units
			The Avenue will also have a retail area of about 86,000 sq ft, which will be connected to the subway and should enhance the accessibility of Wanchai South
Completion of the South Island Line	2017	HK Gov't/ MTRC	The terminus is Admiralty station. This will significantly improve the accessibility of Admiralty and Wanchai to people living in the southern part of Hong Kong Island
Renovation of Hopewell Centre	2017	Hopewell	
Completion of Hopewell Centre II	2018	Hopewell	1.1m sq ft GFA, with 1,024 hotel rooms and 0.3m sq ft of retail area
The government may tender the office site in the Tamar Basin	2015-2020	HK Gov't	The site could be developed into about 0.36m sq ft of offices and would be an opportunity for Swire Properties to expand its Pacific Place portfolio
Completion of phase two of the Shatin-Central Link	2020	HK Gov't/ MTRC	The terminus is Admiralty station. This will significantly improve the accessibility of Admiralty and Wanchai to people living in Kowloon and the New Territories
The government is due to complete the relocation of the Immigration Department to Tseung Kwan O	2020	SAR	The redevelopment of the 3 government buildings in Wanchai could provide sites for developing up to about 2m sq ft of offices

Source: Daiwa

Swire Properties: rental income from Pacific Place offices vs. Central Grade-A offices



Source: CEIC, Company, Daiwa

Indeed, our view is that Central is expanding and that the Greater Central area could eventually stretch from Shun Tak Centre in Sheung Wan to where Pacific Place ends in Wanchai South. Within this cluster, we see 2 main clusters of commercial properties in general. At present, the one owned by Hongkong Land is larger and more mature than the one owned by Swire Properties. However, Swire Properties' Pacific Place portfolio is not much smaller and has been catching up over the past 10 years.

If Swire Properties were to win the tender to redevelop the Queensway Plaza site, and if it were to redevelop some of its existing old buildings in Wanchai, we think the enlarged Pacific Place could emerge as a portfolio in Central comparable to that of Hongkong Land's core Central portfolio, in terms of scale. But Swire Properties' redeveloped buildings would be much younger and much more advanced in terms of building specs.

With the opening of the South Island Line and the Shatin Central Link (by end-2017 and end-2021, on our estimates), Admiralty will become the only other MTR station where 4 subway lines intersect (the other is Central). And this should enrich the "ecosystem" and connectivity of the Admiralty area, in our view.

Meanwhile, there is now more going on after work at 3 Garden Road after the asset enhancement initiative (AEI) work carried out by Champion REIT, and 3 Garden Road-Cheung Kong Center and the Bank of China Building collectively can be seen as cluster within the Central office area. This cluster is just as close to Pacific Place as to core Central. Behind 3 Garden Road, Murray Building is now being developed into a luxury hotel, while the tender to redevelop the Murray Road carpark is likely to open in 4Q16 and Hutchison House is also likely to be redeveloped in the next 2-3 years. These are all developments that should be positive for Pacific Place's position in Central, in our view.

We do not expect Pacific Place ever to replace core Central. However, we expect Central to become larger, richer and stronger, and we believe it is large enough to accommodate 2 major commercial portfolios. Hence, we contend that Pacific Place has the potential to become 1 of the 2 largest single-landlord commercial portfolios in Central.

Pacific Place: its evolution

Period	Comments
1980s	The former Victoria Barracks, a large piece of land close to the edge of Central
1990s	Pacific Place becomes recognised as one of the most high-end integrated commercial property complexes in Hong Kong, with Pacific Place offices being seen as a major office area in fringe Central
2000s	It becomes an integral part of the Central area and Pacific Place's eastward expansion drives the expansion of the boundary of Greater Central
By 2020	The eastward expansion into Wanchai South continues to improve the scale and importance of this new cluster of commercial properties within the Greater Central area, which should be helped by the completion of 2 railway lines (South Island Line by 2016 and Shatin-Central Link over 2020-22)
2030s	Redevelopment of the 3 government buildings in North Wanchai and potentially other sites (such as Queensway Plaza) could improve the scale and importance of this cluster in the Greater Central CBD

Source: Daiwa

Greater Pacific Place, as a part of Greater Central

Source: Company, Google, HKSAR Government, Daiwa

Our view is that mixed developments (including offices, retail, hotels and serviced apartments) have merits and, if executed well, such portfolios tend to be more resilient during industry downturns and can recover just as fast when the upturn arrives. And we envisage that Central could have 2 large-scale single-landlord-owned mixed-property portfolios in the future (ie, Hongkong Land's core Central portfolio and Swire Properties' Pacific Place portfolio).

In other words, we think Pacific Place is a lot more than just the Pacific Place mall and despite the difficulties (ie, the decline in tenant sales) the mall is facing, we think the best of times for Pacific Place are yet to come.

Pacific Place vs. Hongkong Land's core Central portfolio

	Pacific Place (GFA, m sq ft)	HK Land Central portfolio (GFA, m sq ft)	Taikoo Place (GFA, m sq ft)*
Office	2.4	4.9	8.3
Retail	0.7	1.1	1.4
Serviced apartments	0.4	-	0.1
Hotels	1.8	0.2	0.2
Total	**5.4**	**6.1**	**10.0**
No. of office buildings	**5**	**10**	**12**

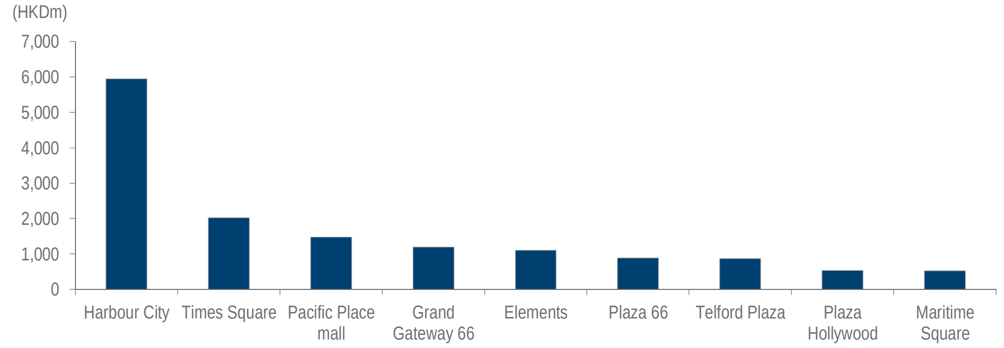
Source: Daiwa
*Note: * upon completion of One and Two Taikoo Place*

Which brings us to this question: What really is the problem of Pacific Place mall? How bad is the situation? And is this an addressable and cyclical issue or a structural one that will continue and deepen?

The stock market seems to have the perception that the Pacific Place mall is currently the weakest mall in Hong Kong and that it has been struggling hard. That retail sales at the mall have been on the decline in recent years is not in doubt. However, based on its financial performance (see below), it is still a highly productive asset.

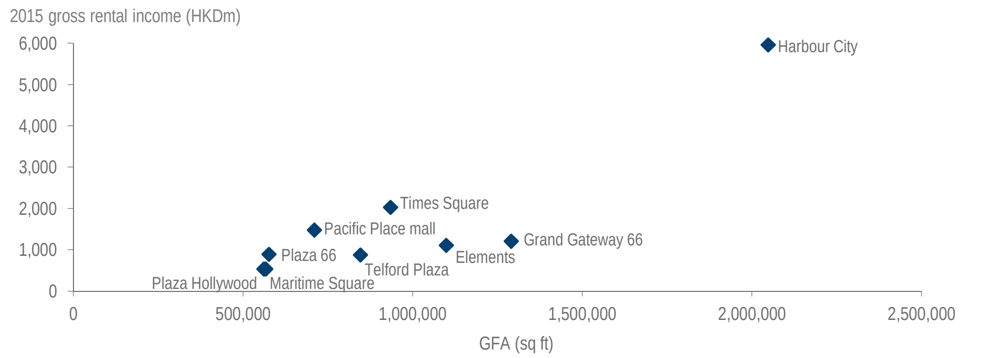
We say this because in terms of rental income and, more importantly, rental income relative to size, Pacific Place mall appears to still rank high by global standards, based on our industry research. In terms of its achieved rental income, it still ranks high among the malls in Hong Kong, on our estimates, though in terms of visitor traffic and tenant sales, it has declined notably from previous days.

Gross rental income from the various major retail properties in Hong Kong in 2015



Source: Companies, Daiwa

Gross rental income and size of various major retail properties in Hong Kong



Source: Companies, Daiwa

So then, what really is the problem for Pacific Place mall? In one sentence, we think the main issue is that since the 2010s, the mall has made a concerted shift towards the luxury end of the spectrum only to find, once the shift was completed, that luxury items were no longer consumers' main focus.

But is it a mistake for Pacific Place to position itself largely as a high-end mall? What is the right balance between luxury brands and other retail segments? Are high-end malls a different kind of mall compared with those targeting the mass market? What are the main yardsticks we can use to evaluate high-end malls? These are not simple or easy questions to answer.

One point that is often not well understood is that of all the various property assets, retail malls are actually the most difficult to analyse and manage. And among retail malls, high-end malls are probably the most difficult to manage and analyse.

Pacific Place mall

Source: Daiwa

Of course, almost anyone could find something to say about any mall in terms of traffic flow, perceived vibrancy, etc., and it appears that this is how most people formulate their assessment of malls. But we see these elements as just the starting point when it comes to analysing a mall. Ascertaining the value and potential of a mall requires much more skill, in our view. As the founder of a leading China property company put it, the mass-market residential-housing sector functions like a primary-school business (in terms of the skill-set required), developing villas functions like a university-level business, while developing and managing shopping malls is really a business that functions like a post-graduate level business.

Yes, a mall is just a place where people come to shop. But that mall can have 100-300 tenants, or more, and the managers need to decide how to create the most appropriate mix, how to place the tenants on the various floors and positions within the mall, how to ensure that the mall can evolve in time and along with changing consumer preferences and spending patterns. This is as much an art as a science. As Warren Buffett puts it, "people are creatures of habit", so ensuring that people with purchasing power get into the habit of coming and shopping repeatedly in a certain mall and that this group of people will keep on growing is a complex, management-intensive exercise.

Compounding this is the fact that it is not the landlords who sell goods or services to shoppers. It is the tenants. From a landlord's perspective, working out the tenant mix well so that all the players become collectively stronger is difficult. Where to put each tenant? How to ensure that they have the right shop size? How to attract more shoppers to the mall? How to improve the shopper circulation in the mall? How to ensure shoppers return? How to strike a balance between achieved rents and foot traffic? These are all issues that only expertise and experience can resolve.

Contrary to popular belief, attracting more foot traffic is arguably the easiest part of the business, in our view. All you need is a large enough mall in a reasonably well-located area, fill it with a food hall, a cinema, an ice-skating ring, a big supermarket and a large department store, then the mall is likely to win decent foot traffic. However, such a mall may not generate meaningful returns for the developer. This is because cinemas, ice-skating rinks and F&B outlets usually do not pay high unit rents. And a mall full of these outlets does not, in our view, have too much development potential in that it is unlikely to be able to take market share from other malls over the long term, which would be a key way for it to drive its tenant sales growth at a pace consistently above its peers.

As a rule of thumb, the rent-paying capability of a tenant is determined by the operating profit per sq ft that it can generate from its business. Generally speaking, luxury brands, because of their large ticket sizes and fat margins, tend to generate much higher sales productivity per sq ft of space occupied. They tend to represent the cream within the mall industry, and they are generally selective when it comes to choosing which mall(s) they take space in.

These are the tenants that most malls are just not able to attract. Hence, from a pure financial return and positioning perspective, we say that it is probably rational and sensible to include as many luxury brands as possible in the mix, as long as doing so does not adversely affect the longer-term development potential of the mall. Herein lies one of the most difficult dilemmas and execution challenges faced by managers of high-end malls. And this is probably the reason why pure high-end malls rarely work globally.

There are quite a few medium-sized pure high-end malls in some of China's cities. These malls have had their heyday and most have been struggling as China's tradition of conspicuous gift consumption has been eased out by the China government's anti-graft campaign, making it very hard for these malls to reinvent themselves. Bal-Harbour Shops in Miami is often quoted in the media as one successful example of a pure high-end mall, but our read is that even Bal-Harbour is not comprised of exclusively high-end brands.

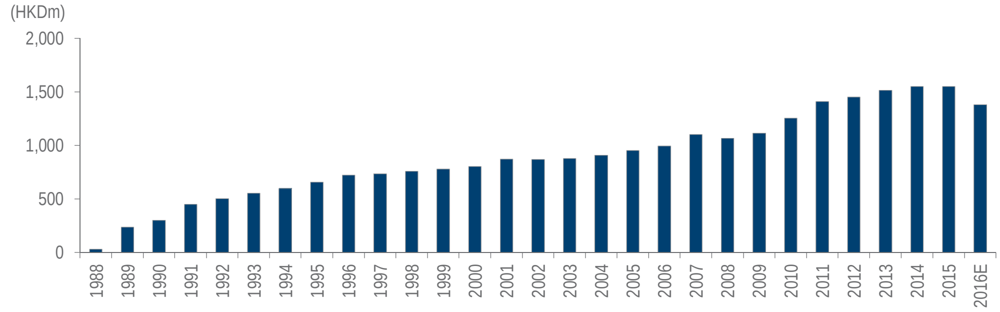
Yes, filling a mall with luxury brands could generate significant tenant sales — and hence rental income — even if it has little traffic, as long as the average ticket size is large enough and that the regular shoppers really like shopping repeatedly in that mall. However, making this sustainable is tricky and difficult. This is because most high-end malls usually have an image of being exclusive and only for the privileged few. Thus, if that mall fails to attract new and loyal shoppers with comparable purchasing power to previous shoppers, or if consumer tastes change or if the mall loses key customers, then that mall could run into problems.

In short, creating a high-end mall that is seen as being exclusive enough for the rich but at the same time welcoming enough to most shoppers, as well as ensuring they gain exposure to up-and-coming brands and that they remain frequent visitors, is a complex and difficult balancing act. One where few in the global property arena have succeeded thus far.

Looking back, we could say that this was the main overall challenge faced by Pacific Place mall. A few years ago, luxury retail sales were booming in Hong Kong and many brands wanted a much larger presence in Pacific Place mall. As such, they were willing to pay much higher rents than other tenants. However, Pacific Place mall is not that large (it has a GFA of only 0.7m sq ft vs. 2 m sq ft at Harbour City), hence accommodating more luxury brands has inevitably meant that some brands and retail segments have had to leave.

We have seen this with Pacific Place mall, which has extended the presence of luxury brands beyond Level 3 to Level 4 and then to Levels 1 and 2. From a pure financial point of view, such a change has resulted in considerable financial benefits. And the mall has seen a nice surge in its gross rental income over the past 5 years.

Gross rental income from Pacific Place mall



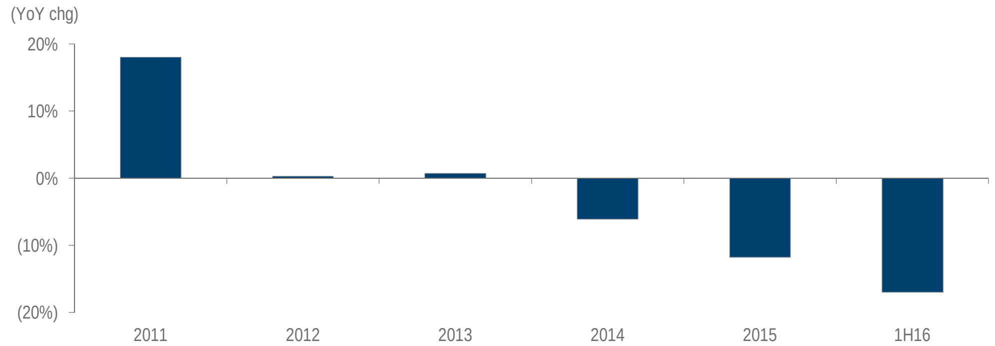
Source: Company, Daiwa

But the increase in rental income came at a price. For luxury brands, what matters most is ticket size and these brands do not need too many shoppers to meet their sales targets. Indeed, some wealthy shoppers may well prefer the mall to be quieter and exclusive. As a result, allocating more space to luxury brands has not resulted in incremental foot traffic to Pacific Place mall. On the contrary, the inclusion of more luxury brands could give the impression that the mall is aimed at the exclusive few.

As such, we would say that Pacific Place mall has achieved a notable rise in rental income after including more luxury brands, but the trade-off has been foot traffic and consumer perception.

Meanwhile, by the time Pacific Place mall had completed its shift into the luxury segment, China's luxury spending had started to decline (in about 2013). Hence, Pacific Place mall faced a double whammy over 2013-15. The increase in luxury spending that the mall's manager had expected has not materialised, and it has lost foot traffic and consumer spending to other malls because of the move into luxury. At the same time, the mall's image and identity among consumers also appear to have suffered.

Swire Properties: YoY change in tenant sales at Pacific Place mall



Source: Company

But is this problem cyclical or structural? We think it could be both, depending on how capable the mall manager is in addressing it.

Pacific Place mall appears to have been in a kind of vicious cycle over recent years, with underperforming leased luxury retail space coinciding with a loss in consumer traffic. In this light, we believe the key is to break the vicious cycle and kickstart a virtuous cycle, characterised by more foot traffic and the return of popular brands, improving tenant sales, and then even more foot traffic and even more promising tenants returning to the mall. And if this happens, then the virtuous cycle could keep going.

Conceptually, fine-tuning and repositioning is nothing new for a shopping mall. Our view is that retail property is a very management-intensive business. We believe that a mall needs to co-evolve with its customers and the times, as well as with changing consumer perceptions of different brands. As such, a manager needs to constantly fine-tune its tenant mix, introducing up-and-coming brands, and ensure that it is at the forefront of retail trends. Or in property parlance, the manager needs to remain "strong and relevant".

Against this backdrop, fine-tuning and adapting is something a mall has to do almost every day and some setbacks are bound to happen at certain periods in its life. The strength of a mall comes precisely from its ability to adapt, to respond and continue to reinvent itself in face of changing consumer tastes. From this perspective, Pacific Place mall is now facing a challenge but we think it is one that can be overcome. Indeed, how well Pacific Place Mall can recalibrate itself will serve as an acid test of Swire Properties' retail-management capability.

Thus, we think Pacific Place mall's challenges pose a risk to the company that is manageable in the context of the whole Pacific Place portfolio, which has become increasingly office-centric. Moreover, our view is that the challenges faced by Pacific Place mall can be overcome and are not necessarily structural.

We believe that the following 5 points need to be made:

1. We believe that Swire Properties has shown the determination and commitment to address the issues facing Pacific Place mall. From our on-the-ground research, we have seen that the manager has come up with a plan to recalibrate the mall, and this started several months ago, with more F&B outlets and smaller pop-up stores. Moreover, we understand from management that this will be an ongoing exercise and expect it to take 12-18 months to roll out fully. Also, a major lease in the mall should expire by about 2019. Hence, in the next 3-4 years, we expect to see the continuous refinement of Pacific Place mall. Thus, we think that management is committed to revamping the mall.

New developments in Pacific Place mall (2016)

Source: Daiwa

2. We don’t think that any of the mall’s major tenants or brands have given up on it. Notwithstanding all the talk about luxury retailers closing stores in weaker malls, we are not aware of any major luxury brands trying to leave Pacific Place mall. What we know is that, so far, these brands have been talking to the manager about resetting or optimising their desired floor space, and that this should attest to the confidence that these retailers have in Swire Properties’ ability to address the issues facing the mall.

3. The repositioning of Pacific Place mall is not really a new concept. Since it opened in the late-1980s, the mall has undergone many changes. As we see it, the space had long been seen as an elegant luxury mall that also welcomed mass-market shoppers. But when it made the shift to housing more luxury brands, it was seen by many as being not as welcoming as before, resulting in a loss of traffic, tenant sales and vibrancy.

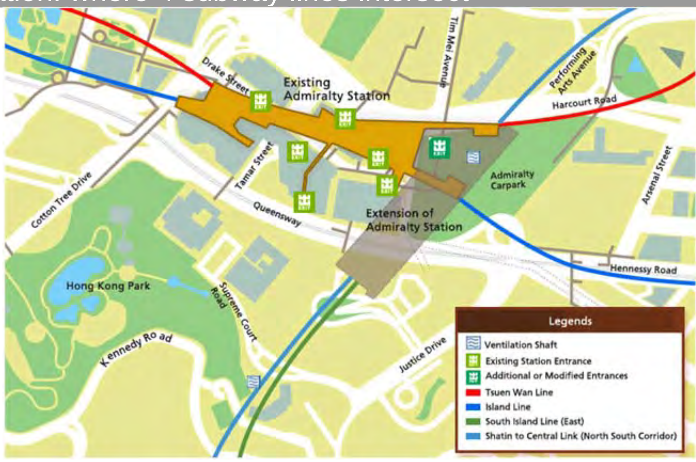
In this light, the mall probably doesn't need to reinvent itself entirely. We wonder if all that is needed is for the manager to right-size the luxury component, and lure back some of its lost customers, as well as bringing in more new and up-and-coming retailers. In other words, the magic ingredient could be that it just needs to go back to what it was doing before it went on the hunt for full-on luxury status.

4. There are other things working in Pacific Place mall’s favour. One is the improvement in the transportation infrastructure that will eventually make Admiralty one of the only 2 locations in Hong Kong where 4 subway lines intersect. Moreover, the office proportion of the mall has been doing well and Wanchai South keeps on changing and improving, which should lead to positive spill-over effects for Pacific Place over time. Also, the mall’s connectivity and the affluence of its catchment area have not deteriorated. Indeed, these elements continue to improve.

Admiralty Station: terminus for the South Island Line

Source: MTR, Daiwa

Admiralty Station: where 4 subway lines intersect



Source: MTR, Daiwa

Admiralty Station: the terminus for the Shatin-Central Link

Source: MTR, Daiwa

5. While Swire Properties has lost some market share within the Hong Kong retail property sector in recent years, it has been doing well at managing its retail malls in China. Many of its malls on the Mainland are widely seen as some of the few that can bring in a lot of tenants and shoppers who are more trendy and lifestyle-orientated. At the same time, our read is that Cityplaza in Taikoo Place has been improving as a retail property.

Thus, we believe it is too early to say that Swire Properties has lost some of its ability to manage retail properties. While it has faced some setbacks in Hong Kong in recent years, it has achieved considerable improvements in managing its retail property assets in China over the same period. We believe it still has the retail management expertise. What it needs to do is apply what it has learnt over the years to recalibrate Pacific Place mall in a way that ensures it can regain some of the ground it has lost.

Overall, we think it is important to examine Pacific Place mall's situation in the context of the whole Pacific Place complex, which we see as a large-scale and growing mixed property development project. We also need to look at it against the backdrop of how it has evolved and developed since its early days. Thus, we think it is too early to give up on the Pacific Place mall and that the whole development still has considerable room for improvement.

One more point to note, though, is that the repositioning of Pacific Place mall is not just about replacing luxury brands with F&B outlets. In all likelihood, the third floor of the mall will remain targeted at luxury brands, just as it has always been. In the past 5 years, the luxury brands have moved onto the fourth floor, as well having some presence on all the others, and we expect this approach to be scaled back a bit. Also worth noting is that while F&B rents are usually not as high as those for luxury brands, the up-and-coming luxury brands could be paying unit rents that are as high as those for the traditional luxury brands (especially if their shops are smaller).

Our understanding is that a major part of the recalibration of Pacific Place mall is about replacing old and tired tenants with newer, more dynamic and more productive ones, as well as right-sizing the luxury component of the mall. Saying that, we are not expecting a significant reduction in rent for Pacific Place mall (for 1H16, we estimate that the base rent in the mall declined by just about 2% YoY, and that the 3.7% YoY decline in Swire Properties' retail rental income in Hong Kong for the same period was caused largely by a decline in its received turnover rent). While the mall's current occupancy cost is about 20%, which is at the higher end of its past 25-year range, we think 20% is acceptable for the high-end malls.

However, even if the rental income generated by Pacific Place mall were to decline by 10-20% over the coming years, we would see this as bearable given that the company should see growing rental income from its offices and China segments. In any case, the office business has long overtaken its retail segment as the most important source of rental income at Pacific Place and hence we would expect investor concerns as to the rental income downside potential to be limited.

Swire Properties: quarterly KPIs (retail properties in Hong Kong)

	2012	2013	2014	1Q15	1H15	9M15	2015	1Q16	1H16
HONG KONG									
Pacific Place mall									
Occupancy (period end)	100%	100%	100%	100%	100%	100%	100%	100%	100%
Retail sales growth	+0.3%	+0.7%	-6.1%	-14.5%	-12.7%	-13.7%	-11.8%	-15.4%	-17.0%
Cityplaza Mall									
Occupancy (period end)	100%	100%	100%	100%	100%	100%	100%	100%	100%
Retail sales growth	+6.0%	+2.4%	-0.4%	+11.3%	+10.9%	+6.7%	+0.7%	-3.9%	-4.1%
Citygate Mall									
Occupancy (period end)	100%	100%	100%	100%	100%	100%	100%	100%	100%
Retail sales growth	+21.2%	+13.5%	+4.6%	-2.3%	-5.3%	-7.9%	-10.0%	-14.0%	-13.0%

Source: Company, Daiwa

Question 4

Has the market underestimated Swire Properties’ potential in the Hong Kong office market?

Q4: Has the market underestimated Swire's potential in HK office?

"We choose to go to the Moon. We choose to go to the Moon not because it is easy – but because it is hard."

\- J.F. Kennedy

"It is Enterprise which builds and improves the world's possessions…If Enterprise is afoot, wealth accumulates whatever may be happening to Thrift; and if Enterprise is asleep, wealth decays whatever Thrift may be doing…

Most probably, of our decisions to do something positive, the full consequence of which will be drawn over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction…."

\- John Maynard Keynes

The misconception

Swire Properties is the largest Grade-A office landlord in Hong Kong in terms of both floor area and rental income from this property segment. It is also poised to expand its portfolio by the largest magnitude over the next few years, and has committed to invest the largest amount in the sector. Against this background, one would think Swire Properties would have solid credentials and would be seen by the stock market as *the* play on the Hong Kong office market.

However, this is not the way the stock market views Swire Properties, at least not yet. We see various reasons for this, and below outline the major reasons:

1. Hongkong Land is perceived as *the* office landlord in Hong Kong with its long history in the market.
2. Swire Properties derives a large portion of its office rental income from Taikoo Place in Island East, but global investors are much more familiar with Central.
3. The image that Swire Properties is all about Pacific Place is an entrenched and sticky one.
4. Swire Properties' office portfolio does not fit clearly into either of the centralised/decentralised office themes, which has been a common (though somewhat simplistic in our view) way for investors to play the Hong Kong office market. It has both, and as such doesn't fit perfectly into either.

Perceptions are perceptions, and cannot be changed quickly. That said, Swire Properties' significant and attractive exposure to the Hong Kong Grade-A office sector would likely be increasingly recognised by the stock market for the following reasons:

1. Taikoo Place should be approaching the inflection point in its next leap, if not having already entered it

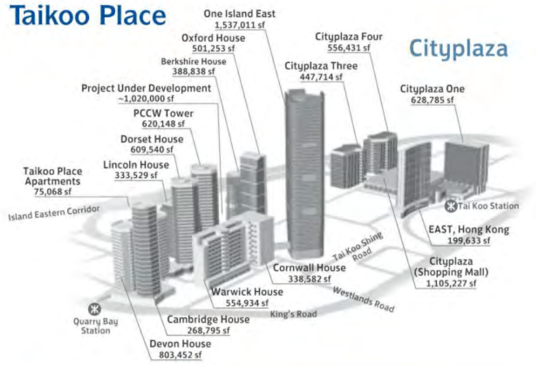
In our opinion, the transformation of Taikoo Place into a premier commercial hub represents probably the largest value creation the Hong Kong office sector has seen in recent decades. Essentially, Taikoo Place has gone from an industrial area in the past, to later a back-office location for banks and multinationals, and then to a front office location for all kinds of industries ranging from insurance, trading to advertising, luxury brands, IT and more recently international law firms (essentially all major multinationals except finance).

The evolution of Island East

Period	The location's evolution
1970s	A dockyard in a remote part of Hong Kong Island
1980s	Became a residential area, with Taikoo Shing recognised as a classic mass residential housing estate for the middle and upper-middle class, with more than 12,000 residential units
1990s	Island East first started as an office location for banks' back offices but later became recognised as a new area for decentralised offices
2000s	Island East became the first large-scale commercial centre outside Central, with a GFA of over 8m sq ft of office space
By 2020	Could become a premier and the largest commercial hub outside Central
	Could be a major commercial hub with sizeable office spaces alongside a vibrant retail area, hotels, as well as cultural and entertainment components

Source: Daiwa

Swire Properties: Taikoo Place



Source: Company

Importantly, we believe that Taikoo Place as an office hub is now on the verge of another major leap forward and the latest influx of international law firms to relocate to the area (such as Ince & Co, and Berwin Leighton Paisner [BLP] and luxury brands [such as Burberry]) bodes well for the prospect of the area making another leap forward in the years to come. Moreover, we see Swire Properties' redevelopment of 3 techno-centres into 2 Grade-A office towers (One Taikoo Place and Two Taikoo Place) as the impetus driving Taikoo Place to its next stage.

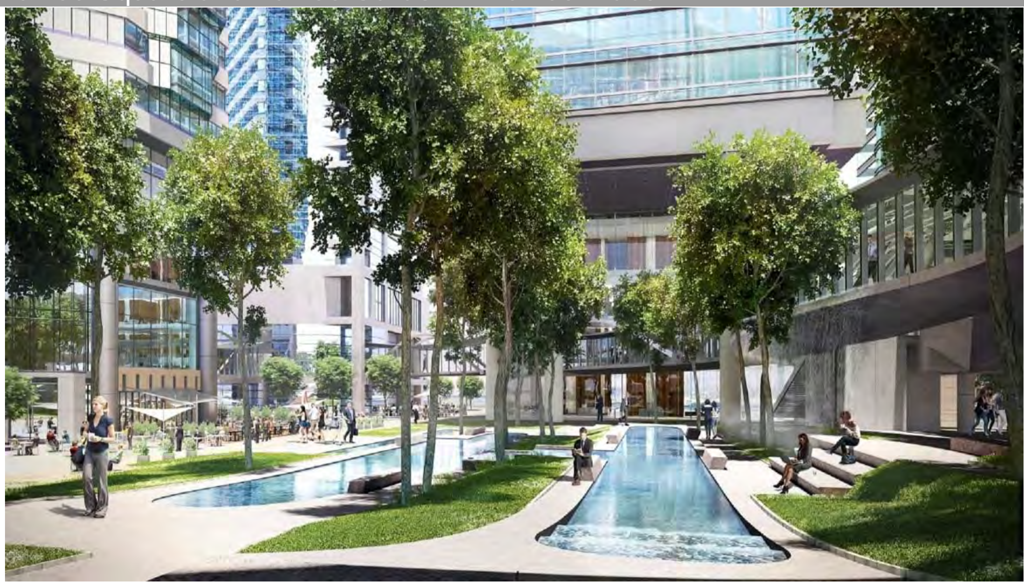
These 2 office buildings (scheduled to be completed in 2018 and 2021) have the highest building specifications seen in Hong Kong so far, thus giving it the credential to appeal to top quality tenants in the office space, including major banks and asset management companies.

Moreover, the redevelopment of the 3 techno-centres will make it possible for the creation of a large public area of 60,000 sq ft, which would be larger than Statute Square in front of the HSBC Building in Central. As such, we believe the ambience of the entire Taikoo Place will be substantially improved from now. Essentially, Swire Properties will have 12 office buildings in Taikoo Place, comprising 3 super office buildings (One Taikoo Place, Two Taikoo Place, One Island East), 4 older ones (Cityplaza One, Cityplaza Three, City Plaza Four, Berkshire House) and 5 in the middle (Dorset House, PCCW Tower, Devon House, Oxford House, Cambridge House), which together make up over 8m sq ft GFA of offices (about 1.6x Hongkong Land's office portfolio in Central in terms of GFA, we estimate), a size which we believe has critical mass.

Swire Properties: proposed redevelopment of techno-centres

Source: Company

Taikoo Square and Taikoo Garden in Taikoo Place



Source: Company

Master plan of Taikoo Place by 2021

Source: Company

We note that these 8m sq ft of offices will be supplemented by a 1.1m sq ft mall as well as a 0.2m sq ft hotel and a serviced apartment with 0.08m sq ft of serviced apartments. Essentially, the group will occupy a 10m sq ft portfolio in the area. This size is almost double that of Hongkong Land’s core Central portfolio in terms of GFA, and we see it as one that offers sufficient critical mass for the Taikoo Place story to establish its own “ecosystem”. We expect this ecosystem to gradually assume a life of its own, especially if it is supplemented by Swire Properties’ continuous efforts to strengthen such a portfolio (through for example, continuous redeveloping the old buildings it has acquired in the area etc.).

Swire Properties: evolution of its Taikoo Place portfolio

Properties	Area	Year of completion	Office GFA (sq ft)	Techno Centres GFA (sq ft)	Retail GFA (sq ft)	Hotel GFA (sq ft)	Serviced apartments GFA (sq ft)	Total GFA (sq ft)	Cumulative GFA (sq ft)	No. of rooms	No. of car parks
Commercial areas, Taikoo Shing	Island East	1977-1985	-	-	311,079	-	-	311,079	311,079		3,826
Warwick House	Island East	1979	-	554,934	-	-	-	554,934	866,013		
Cityplaza	Island East	1983	-	-	1,105,227	-	-	1,105,227	1,971,240		834
Cornwall House	Island East	1984	-	338,369	-	-	-	338,369	2,309,609		
Somerset House	Island East	1988	-	923,364	-	-	-	923,364	3,232,973		285
Cityplaza Four	Island East	1991	447,709	-	-	-	-	447,709	3,680,682		217
Cityplaza Three*	Island East	1992	423,785	-	-	-	-	423,785	4,104,467		
Devon House	Island East	1993	803,448	-	-	-	-	803,448	4,907,915		311
PCCW Tower	Island East	1994	310,074	-	-	-	-	310,074	5,217,989		
Dorset House	Island East	1994	609,540	-	-	-	-	609,540	5,827,529		215
Cityplaza One	Island East	1997	628,785	-	-	-	-	628,785	6,456,314		
Lincoln House	Island East	1998	333,350	-	-	-	-	333,350	6,789,664		164
Oxford House	Island East	1999	501,249	-	-	-	-	501,249	7,290,913		182
Cambridge House	Island East	2003	268,793	-	-	-	-	268,793	7,559,706		
One Island East	Island East	2008	1,537,011	-	-	-	-	1,537,011	9,096,717		
The EAST	Island East	2009	-	-	-	199,633	-	199,633	9,296,350	345	
DCH Commercial Centre	Island East	2013	194,500	-	-	-	-	194,500	9,490,850		
Cornwall House (8 extra floors)*	Island East	2014	-	187,000	-	-	-	187,000	9,677,850		
Taikoo Place Apartments	Island East	2014	-	-	12,471	-	62,658	75,129	9,752,979		
Sub-total			**6,058,244**	**2,003,667**	**1,428,777**	**199,633**	**-**	**9,752,979**			
Redevelopment of Somerset House (One Taikoo Place)	Island East	2018	1,000,000	-	-	-	-				
Redevelopment of Cornwall and Warwick House (Two Taikoo Place)	Island East	2021	1,080,303	-	-	-	-				
			8,138,547	**-**	**1,428,777**	**199,633**	**62,658**				

Source: Company, Daiwa
*Note: * we have adjusted the data for the 10 floors given to the government*

Furthermore, the current rental trend in the Hong Kong office market as a whole presents Taikoo Place with an opportunity, in our view. Rents for premier office space in Taikoo Place are in the HKD50-60/sq ft range currently, which is about half the prevailing rents in premier Grade-A office buildings in Central. Our view on the current office cycle is that the entry of Chinese financial institutions and other firms with higher rent-paying capacity will crowd out some of the traditional occupiers of office space in Central, which in turn would have a knock-on effect on the Hong Kong office sector, with some tenants needing to relocate.

We see Swire Properties' new office buildings in Taikoo Place being in a good position to capture such demand. Further in favour of Taikoo Place, and probably Pacific Place as well, is that a few years back, the government decided to occupy the Tamar site for its own offices and did not redevelop its 3 office buildings in Wanchai earlier. If it had carried out this development, those new office buildings would likely have had some priority in terms of benefiting from the over-flow of tenants from Central.

As things stand today, there are pretty much only 3 major Grade-A office buildings to be completed in the traditional core office areas in the next month. One is Lee Gardens Three developed by Hysan, and the other 2 are One Taikoo Place and Two Taikoo Place developed by Swire Properties.

In short, we think the next few years will offer a golden opportunity for Taikoo Place in terms of establishing itself as the second-largest commercial hub for offices on Hong Kong Island, or even a location for finance and professionals that it as credible as Causeway Bay.

Note that Swire Properties has altogether about 10m sq ft GFA of commercial properties in Taikoo Place and we estimate that their book cost is under HKD100bn, while we appraise their latest market value to be HKD118bn (HKD11,650/sq ft blended). Given the prices recently achieved by some en-bloc buildings in Kowloon East, Hunghom, Wanchai and Sheung Wan, we see considerable room for an uplift in the valuation of Swire Properties' commercial property assets in Taikoo Place. Given that the size of Swire Properties' Taikoo Place portfolio is so large, every HKD1,000/sq ft rise in their capital value would translate into some HKD10bn market value or HKD1.71/share, on our estimates.

Taikoo Place

Source: Company, Daiwa

We expect Taikoo Place to account for a rising proportion of Swire Properties’ income and NAV, and estimate it will account for about 50% of Swire Properties’ gross rental income by 2021 when Two Taikoo Place is completed , which would be over 5x that of the Pacific Place mall. Indeed, the gross rental income now generated by Swire Properties’ Taikoo Place portfolio is already 3.5x that generated by the Pacific Place mall.

However, our view is that the market still seems to see Pacific Place mall as a more important asset to Swire Properties than its Taikoo Place portfolio. While we can see why the market has such a perception, we believe the mismatch with reality has become so large that this view cannot be sustained for too long.

The evolution of Taikoo Place

Source: Company, Daiwa

2. Impact of Kowloon East on the office market is more subtle and complex than commonly believed; it may well strengthen Island East

While mainstream views hold that Kowloon East poses a major threat to Island East offices, we see the impact of Kowloon East on the Hong Kong office market as more subtle and complex. In our opinion, Kowloon East is probably the most important development in the Hong Kong office sector in the past 2 decades, but its impact would probably be more multi-dimensional and structural than most realise.

From our perspective, the impact on office supply of Kowloon East is only secondary in importance to the change it has created in the structure of the Hong Kong office market. That is, with Kowloon East, the Hong Kong office sector as a whole will have a much more solid and strong platform and structure from which to leap forward to the next stage, becoming what we see as a healthy and balanced office market for a genuine metropolitan city.

Structure of the Grade-A office stock in Hong Kong

	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 * 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.

The five key office districts in Hong Kong

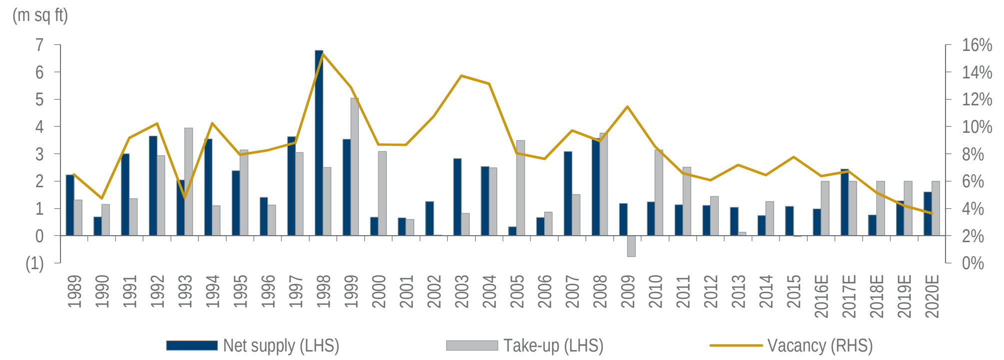
Source: Company, Daiwa

In this light, we believe Kowloon East could become the backbone of the Hong Kong office sector, something the sector has needed for some time. In this sense, Kowloon East would probably make the entire Hong Kong office sector stronger.

Given that the Kowloon East area involves multi-million sq ft of new office supply over the next few years, it is bound to put some competitive pressure on some buildings in the area or other districts. That said, from a broader perspective, we think the Hong Kong office market really needs the new supply from Kowloon East. Paradoxically, based on our understanding and views on how the Hong Kong Grade-A office market has evolved over the years, Kowloon East, even if it creates a temporary over-supply, will still be positive for the Hong Kong office sector overall.

This is because, from our perspective, Hong Kong property is essentially a phenomenon created by a decades-long cumulative under-supply of land. This is the case across the entire spectrum of property asset classes in Hong Kong, with the probable exception of industrial properties or hotels. This scenario has resulted in arguably too much upward pressure flowing into premier assets which has created the risk that these buildings could price themselves out of the market if the situation goes unabated, and end up in a situation where no new entrant can enter this market and existing ones cannot expand. In this light, the new office supply from Kowloon East is necessary to make sure that this office market will not become over-tight and that it is underpinned by a healthy and balanced structure.

Supply, take-up and vacancy rates for Grade-A offices in Hong Kong



Source: CEIC, Daiwa estimates

Essentially, we believe Kowloon East can fulfil 4 key and sorely needed functions in the Hong Kong office market..

1) Value-for-money office space for existing corporations that want to expand.
2) Value-for money office space for potential newcomers into Hong Kong or those that originally desired to be in Hong Kong but have moved elsewhere because this option no longer exists for them.
3) Outlets for tenants for whom existing offices in Central and other office centres have become too expensive to afford.
4) Setting a solid bottom-end benchmark for rental levels in other office locations.

In our view, the new supply from Kowloon East is a necessary challenge the Hong Kong office market needs to face if it is to move forward as an office market for a metropolitan city, which needs scale and a strong and vibrant mid-tier segment. In retrospect, Hong Kong has been fortunate in that it has been home to a number of high-margin corporations that have enabled a few major buildings to achieve a high level of rent in the past. However, tenants that can easily afford to pay HKD100/sq ft plus in rent are the exception rather than the norm, and we do not believe there is any commercial hub in the world that is driven exclusively by the top end.

In short, we see a strong and vibrant mid-end segment as the foundation for a vibrant and sustainable metropolitan property market, and think Kowloon East has provided the office market with precisely this function. We come to this conclusion because we think the main challenge facing the Hong Kong office market is that there is not a large and strong mid-tier segment to accommodate the expansion of existing office occupiers and the arrival of new ones. However, with the emergence of Kowloon East, we think that such an issue has been more or less resolved and believe the office sector has already entered the next stage of its development (ie, phase 3 in the diagram on page 38).

It will be a challenge for the office market to move to stage 3, but it is necessary if the Hong Kong property market is to move from an anomaly and special situation office market to become a genuine and vibrant and sustainable office market appropriate for a genuine metropolitan city.

Moreover, for a variety of reasons, we believe the kind of ordeals and challenges the Hong Kong office sector will face will not be that difficult to address. In short, we like the Hong Kong office market not because of the lack of supply, but rather because there could be abundant supply, thanks to Kowloon East.

The reasons we think the future supply from Kowloon East is not a big concern are as follows.

First, the government's forecast of 3m sq m of office space in Kowloon East in the future includes many redevelopment projects where there is no visibility on feasibility and time table. As we understand it, the supply to come from Kowloon East over the next 3-4 years is not very large, especially if one bears in mind that there is almost no other new supply in other districts other than the redevelopment of old buildings (Sunning Plaza in Causeway Bay; 3 techno-centres in Island East and New World Centre redevelopment in Tsimshatsui).

Relative to the existing stock level of over 80m sq ft, we would see a few million sq ft of new supply as not that large and not higher than Hong Kong's long-term historical average of 1.8m sq ft of new supply annually. It is just that the we are used to limited new supply and high occupancy in the Hong Kong market. However, our view is that if supply is too tight, it would not be in the long-term interests of the sector, as a vibrant office sector needs new-comers and needs to be able to accommodate the expansion demand of the existing office occupiers, to say the least.

Second, the Kowloon East new supply no longer poses a risk to the market overall as it did a few years ago. In retrospect, we think it posed the biggest threat in 2009-12 when some top quality buildings in Kowloon East were asking rents at just a fraction of those in Central, and Kowloon East was seen by many as an unproven office district at the time.

However, our read is that natural market forces have already led to the office market more or less resolving this issue. By about 2013, Kowloon East had already established itself as a major component in the Hong Kong Grade-A office market, with many industries such as shipping, advertising, accounting, consumer goods etc. having accepted Kowloon East as a credible office location. This also drove the achieved rents in the district to rise from just about HKD10/sq ft at the trough in 2008 to over HKD30/sq ft at that time.

Third, relocation costs in Hong Kong are on the rise, probably due to the continuous rise in wages for builders specialising in decoration and removal work. Nowadays, the rental difference needs to be over HKD20/sq ft for rental savings to be meaningful enough for multinational tenants to consider moving in. This is before taking into account the hassle and many other issues associated with office relocation.

With most premier office space in Kowloon East still asking rents in the high HKD30-40/sq ft range, we think it is difficult to imagine many MNCs relocating to Kowloon East from districts other than Central. As we see it, the economics just don't work.

In this light, we believe the current rental level in Kowloon East may well have the effect of reinforcing the current contour of rents in the Hong Kong office market. Current rents of HKD30-45/sq ft in Kowloon East make HKD45-70/sq ft in the 4 core office areas outside Central (Wanchai, Causeway Bay, Island East and Tsimshatsui) and HKD80/sq ft plus rents in Central, look reasonable.

Daiwa's definition of the 5 layers of the HK office market – by relative positioning

Major office markets	Areas	Remarks
I. Greater Central:	Central, Admiralty, Pacific Place's Wanchai extension, Sheung Wan	Central is the core, but will expand and integrate into neighbourhood areas that offer different and complementary office options
II. Four established core office areas:	Wanchai, Causeway Bay, Tsimshatsui & West Kowloon, Island East	Offering alternatives to corporations that may not be finance-centric; Causeway Bay and Tsimshatsui could offer special appeal to retail and fashion-related corporations. We also expect to see some finance companies starting to accept non-Central locations.
III. Kowloon East:	Kowloon Bay, Kwun Tong and Kai Tak redevelopment	Offering alternative office options to corporations in addition to the four established core office areas
		Could meet the owner-occupation demand from premier corporations
IV. Tsimshatsui East, Hunghom, Mongkok	Tsimshatsui East, Hunghom, Mongkok	Offering additional and likely cheaper alternatives to corporations. Supplementing Tsimshatsui as an office location.
V. New satellite office areas:	Wong Chuk Hang, Kwai Chung & Tsuen Wan; Cheung Sha Wan, Tuen Mun, Shatin, Sheung Shui etc.	Could satisfy some of the ownership demand for offices. Do not have sufficient critical mass in their own right, but could satisfy the niche demands of specific industries

Source: Daiwa

In short, the existence of Kowloon East may lead to corporations accepting that the current rent structure in various office districts in Hong Kong is reasonable and conducive to the longer-term development of the sector.

Indeed, our view is that the current contour of office rents in Hong Kong is reasonable, healthy and sustainable. Essentially, the Hong Kong office market currently offers rents ranging from USD2/sq ft to USD20/sq ft per month, and for each rental bracket, we can find districts that can cater to such demand.

In this whole structure, we see Kowloon East as situated in the middle, providing a rental option at USD3-5/sq ft per month. Then, the 4 core office districts outside Central – Wanchai, Causeway Bay, Island East and Tsimshatsui – would provide rental options at USD5-10/sq ft, while Central would be for those corporations whose business could afford rents of USD10-25/sq ft.

We believe that the existing stock and new supply in Kowloon East will enable the area to accommodate many office occupiers. But for corporations which find USD3-5/sq ft to be too expensive, we see areas like Wong Chuk Hang, Kwai Chung, Tsuen Wan etc. providing a rental option at USD2-3/sq ft.

Basically, we see what we refer to as the 5 layers of the Hong Kong office market as a healthy and sustainable structure which is conducive to tenants continuing to find locations that are most appropriate for their business, without distorting or disrupting the entire sector. Our read is that Kowloon East will take over some back office functions previously performed by Island East office and will become a more important back office or middle office location for Central tenants, but we do not expect it to have a major drag on the rents being achieved in other key office districts in Hong Kong.

Indeed, we think Kowloon East will provide the impetus for Island East or other districts to upgrade, which would be healthy and positive for the Hong Kong office market overall, if Island East and Wanchai and Causeway Bay take up some of the tenants flowing out of Central.

Future Grade-A office projects (estimated completion 2016-19)

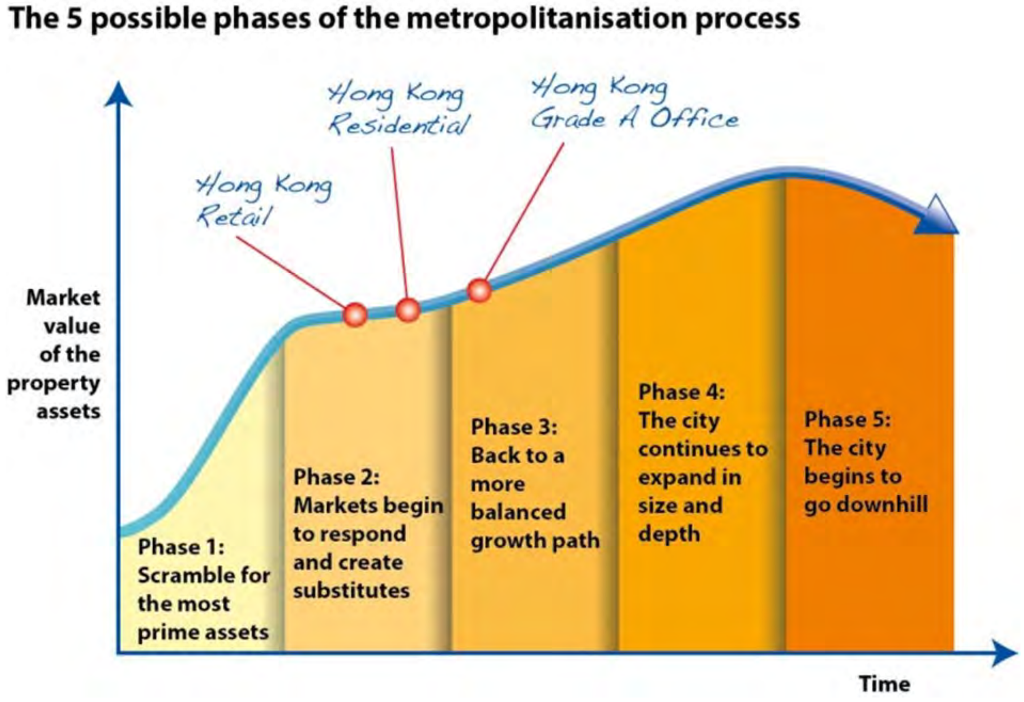
Building name	CBRE district	Area (NFA)	Est'd floor plate size > 15,000 sf (NFA)	Developer	Intended ownership structure	Investment strategy
2016						
One HarbourGate	Hunghom	391,700	No	Wheelock Properties	Strata-title	For Sale
2 Ng Fong Street	San Po Kong	235,700	No	Billion Development	Strata-title	For Sale
33 Tseuk Luk Street	San Po Kong	184,300	No	Sun Hung Kai Properties	Single owner	For Lease
Vertical Sq	Wong Chuk Hang	142,500	No	K Wah Properties	Single owner	For Lease
38 Southside	Wong Chuk Hang	122,000	No	KHI Holdings	Single owner	For Lease
Chinachem Central II	Central	67,600	No	Chinachem	Single owner	For Lease
Chinachem Central I	Central	36,200	No	Chinachem	Single owner	For Lease
2017						
Goldin Financial Global Centre	Kowloon East	639,300	Yes	Goldin Financial	Single owner	For Lease
J/O Hang Yip Street, Wai Yip Street and Kwun Tong Road	Kowloon East	495,200	Yes	Mapletree	Single owner	For Lease
Junction of Wang Chiu Road and Lam Lee Street	Kowloon East	466,200	Yes	Swire Properties	Single owner	For Lease
180 Wai Yip Street	Kowloon East	359,400	No	Sun Hung Kai Properties / Wong's	Strata-title	For Sale
14-30 King Wah Road	Hong Kong East	256,200	No	Henderson Land	Single owner	For Lease
J/O Sheung Yuet Road, Wang Tai Road & Wang Yuen Street	Kowloon East	249,200	No	Hong Kong Pacific	Single owner	For Lease
Asian House redevelopment	Wan Chai	236,300	No	Chinachem	Single owner	For Lease
18-24 Salisbury Road	Tsim Shu Tsui	225,000	Yes	New World	Single owner	For Lease
650 Cheung Sha Wan Road	Cheung Sha Wan	126,200	No	First Group Holding	Strata-title	For Sale
One Harbourfront extension	Hunghom	89,200	Yes	Cheung Kong Property Development	Single owner	For Lease
2018						
Taikoo Place Phase 2A	Hong Kong East	856,800	Yes	Swire Properties	Single owner	For Lease
Lee Garden Three	Causeway Bay	320,300	Yes	Hysan Development	Single owner	For Lease
8-10 Wong Chuk Hang Road	Wong Chuk Hang	286,900	No	Swire Properties & China Motor Bus	Single owner	For Lease
2019						
NKIL 6512	Kowloon East	662,900	Yes	The Link REIT & Nan Fung	Uncertain	Uncertain
Wharf T&T Square redevelopment	Kowloon East	447,200	Yes	Wharf	Uncertain	Uncertain
Kut Cheong Mansion redevelopment	Hong Kong East	365,600	No	New World Dev/Chow Tai Fook	Uncertain	Uncertain

Source: CBRE Research

3. A growing acceptance that the Hong Kong office sector has entered a new chapter
In our opinion, the prevailing investor opinions about the Hong Kong office sector are mixed, with many holding that Hong Kong office rents are at a cyclical peak and will follow the residential and retail sector to correct sooner or later.

Admittedly, office rents so far have not fallen in tandem with residential and retail rents, even though it looks reasonable to expect office rents to follow eventually. However, we contend that this expectation is misguided. In our view, the office market is the leading segment in this cycle, and Hong Kong Grade-A office rents actually adjusted much earlier than residential and retail rents. This adjustment started with Central in 2010, and was then followed by 3 years of disconnect between Central and decentralised areas – whereby Central rents kept on falling during those years, while rents in those decentralised areas help up or indeed rose.

Current position of the 3 property segments in Hong Kong



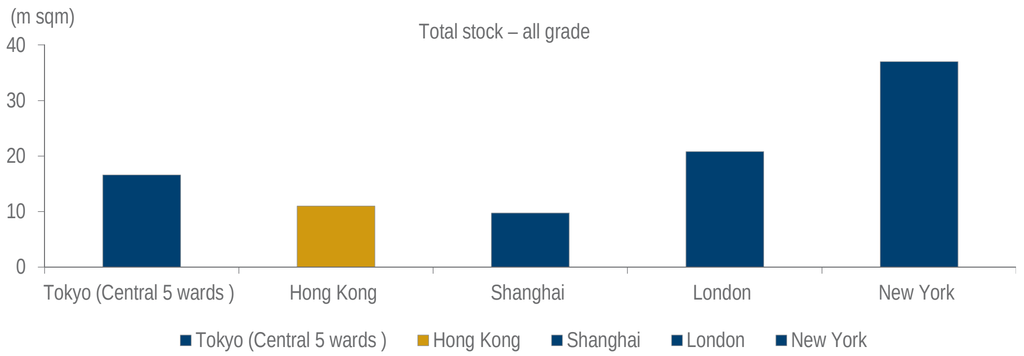
Source: Daiwa

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

All-Grade office stock: Hong Kong vs. other major cities



Source: CBRE Research

We liken what Central underwent in 2010-13 to what some residential properties and retail assets are now undergoing. The situation residential properties and retail assets faced was just too good for too long, and we believe there needs to be a period for the market to clear the excesses created by the boom time they experienced before.

Interestingly, following this line of thinking, we are not surprised to see that rents and prices for the residential market and malls in 2016 YTD have not been as weak as many expected. Just as decentralised Grade-A office rents were able to hold up during 2010-13 when Central rents corrected, it is also conceivable that suburban malls and mass residential housing could also broadly hold up this time.

Admittedly, over the past few years, we have not seen much high profile expansion or new tenants coming to Hong Kong. However, we do not see this situation as being of concern. After all, despite no major news headlines on new-comers into the Hong Kong office sector, all the new supply in Kowloon East and other areas has been fully let, and office vacancy rates in Hong Kong as a whole are at historically low levels.

Major office deals in Hong Kong in recent years

Date	Property assets	District	GFA (sq ft)	Buyer	Vendor	Price (HKDm)	Psf price (HKD/sq ft)
Sep 2016	Golden Centre	Sheung Wan	156,000	Local investor	Henderson Land	4,368	28,000
Jul 2016	One HarbourGate (east tower)	Hunghom	280,000	Cheung Kei Group	Wheelock	4,500	16,071
Jun 2016	The Center (79/F)	Central	13,213	A mainland investor	Hysan's Lee family	500	37,841
Feb 2016	Dah Sing Financial Centre	Wanchai	400,113	China Everbright group	SEA Holdings	10,000	24,992
Nov 2015	MassMutual Tower	Wanchai	345,433	Evergrande	Chinese Estates	12,500	36,186
Nov 2015	One HarbourGate (west tower)	Hunghom	393,000	China Life Insurance	Wheelock	5,850	14,885
Jun 2014	One Bay East (east tower)	Kowloon East	512,000	Citigroup	Wheelock	5,425	10,595
Dec 2013	9 Chong Yip Street	Kowloon East	136,595	Prosperity REIT	Hutchison Whampoa	1,010	7,394
Dec 2013	DCH Commercial Centre	Island East	389,000	Swire Properties & an investment fund	CITIC Pacific	3,900	10,026
May 2013	Kowloon Commerce Centre (5 floors)	Kwai Chung	116,756	China Mobile	SHK Properties	1,027	8,800
May 2013	Citibank Plaza (4 floors)	Central	78,316	Champion REIT	HKSAR Government	2,160	27,581
Apr 2013	One Bay East (west tower)	Kowloon East	512,000	Manulife	Wheelock	4,500	8,789
Feb 2013	113 Argyle Street	Mong Kok	328,866	Hang Seng Bank	Nan Fung (unlisted)	2,900	8,818
Oct 2012	AIA Tower (formerly Stanhope Hse)	Island East	299,615	AIA	Hang Lung Properties	2,398	8,004
Dec 2012	Exchange Tower (7 floors)	Kowloon East	195,875	Hang Seng Bank	Sino Land	1,560	8,000
May 2012	50 Connaught Road	Central	180,000	Agricultural Bank of China	National Electronics	4,880	27,111
Jan 2012	CCB Centre	Kowloon East	348,620	China Construction Bank	Sino Land	2,510	7,200

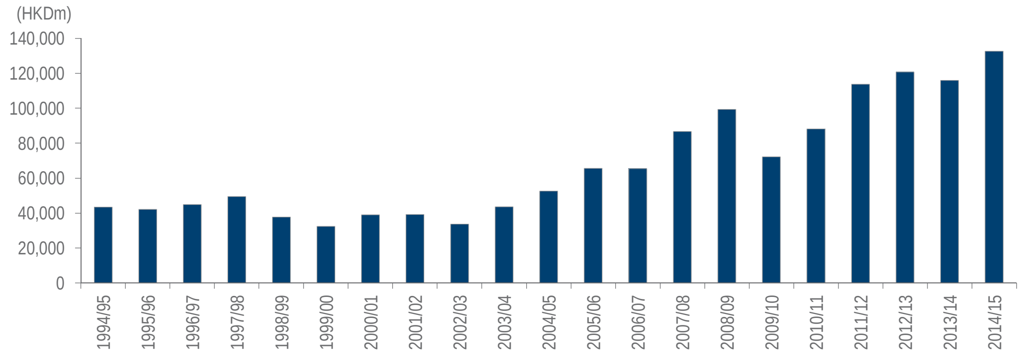
Source: Savills, CBRE, Hong Kong Economic Times, Daiwa

In the meantime, we have seen many large-scale tenant movements, with companies relocating from one district to another. We have also seen many major office occupiers in Hong Kong coming to purchase office space for their own use and long-term expansion. We consider these developments as the market's way of saying that, by and large, the existing tenants want to stay but they just need to find office space which is appropriate to their businesses in the long term.

But we would think that these are precisely the hallmarks of a healthy office market whereby companies are located where they are and paying the rent they are paying not because they have no choice, but because they have judged such an area to be the most appropriate for their business.

Along these lines, we note that corporate profit tax in Hong Kong has kept on rising in recent years and reached an all-time high of close to HKD140bn in 2015. We see this as a sign that the Hong Kong corporate sector's ability to afford office space in Hong Kong is solid.

Corporate profit tax paid in Hong Kong



Source: HKSAR Government

That said, there are no longer reports of large and high profile leasing deals, which were prevalent in the Hong Kong office market in the past. However, this is likely a sign that the Hong Kong office market is maturing and becoming more sophisticated. We think the current occupancy rate for the Hong Kong office sector and the continuous rise in rents for Grade B and Grade C offices in recent years suggest that many firms have been steadily raising their occupied space over the years, and that there are probably smaller firms continuing to come to this market as well.

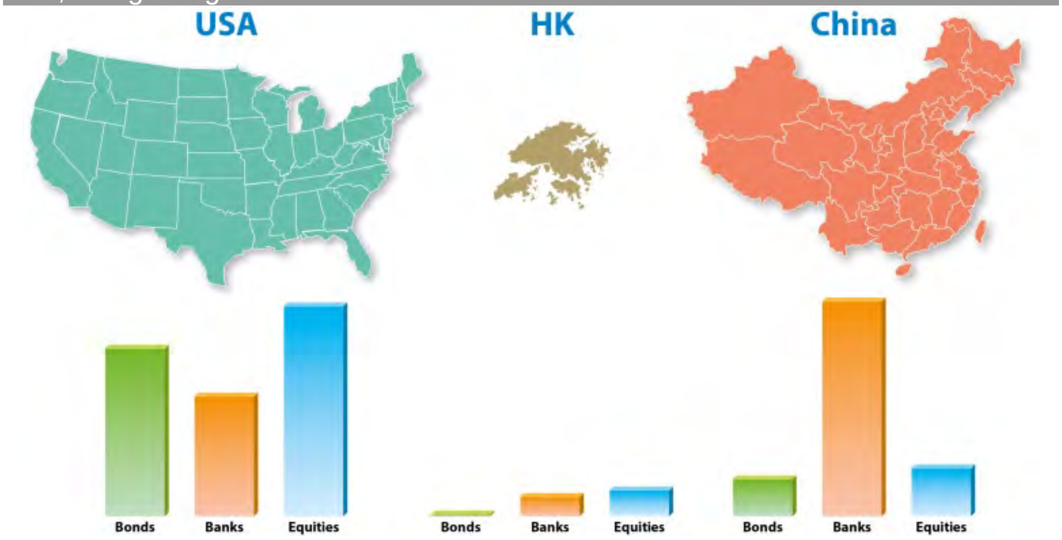
In our view, these are signs of strength, not weakness. We believe the bit-by-bit expansion decisions made by hundreds or thousands of smaller firms can be likened to the revealed judgements of a large number of professional managers of a business, and is often a more accurate and reliable indicator of the business outlook than the high-profile leasing decisions of some large-scale multinationals.

Overall, our view is that the Hong Kong office sector is progressing on a healthy path. If there is no major pick-up in office demand, we would expect the market to be quiet, but we do not expect any material decline in office rents over the next 1-2 years at least. Meanwhile, if there is only a moderate pick-up in demand in the next 3-12 months, this would probably be enough to exert upward pressure on office rents given the current vacancy level and supply situation in the Hong Kong Grade-A office market.

More importantly, we are seeing early signs that the Hong Kong Grade-A office sector could be entering a new phase, with potential new impetus coming from the reform or liberalisation of China's financial sector.

With bank deposits in excess of USD15tn and M2 as large as USD18tn, China has to have a financial sector which can match the size of its economy and its financial assets. Our read is that China's financial sector has been largely one established by it for itself and it does not readily fit into the global financial architecture.

The relative size of banking assets, equity markets and bond markets in the US, Hong Kong and China



Source: Daiwa

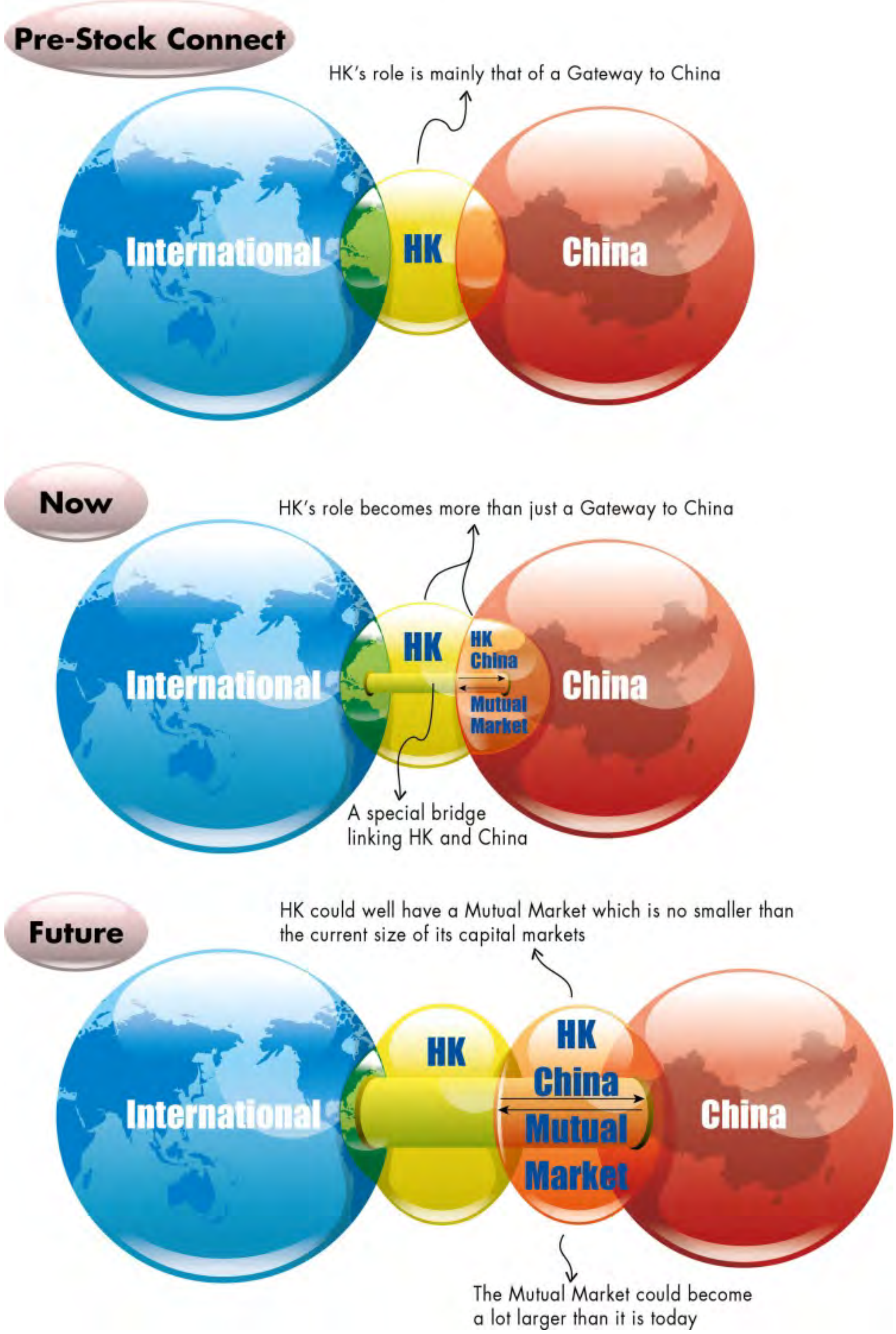
As such, we expect the bulk of China's financial sector will remain on-shore and consist mainly of its own financial institutions. That said, with China's financial sector as large as it is today, we think China's financial sector has to interact with the global financial markets at some point.

Under our base case China's financial sector would remain largely on-shore. That said, it is now theoretically possible for China's financial sector to have an offshore component, thanks to the Shanghai-Hong Kong Stock Connect which has now been expanded to include Shenzhen-Hong Kong Stock Connect. The greatest significance of these schemes, in our view, lies in the breakthrough they offer in terms of institutional structure in China's financial sector, making it technically possible for the country to have an offshore component.

In our opinion, what the Stock Connect (and the associated breakthrough in institutional structure in China's financial sector) means is that a bridge has now been built which can connect capital flowing from China to Hong Kong. It will be up to the creativity, professionalism and dedication of the market participants to determine whether and how well this bridge can be utilised – but the bridge has been built nonetheless.

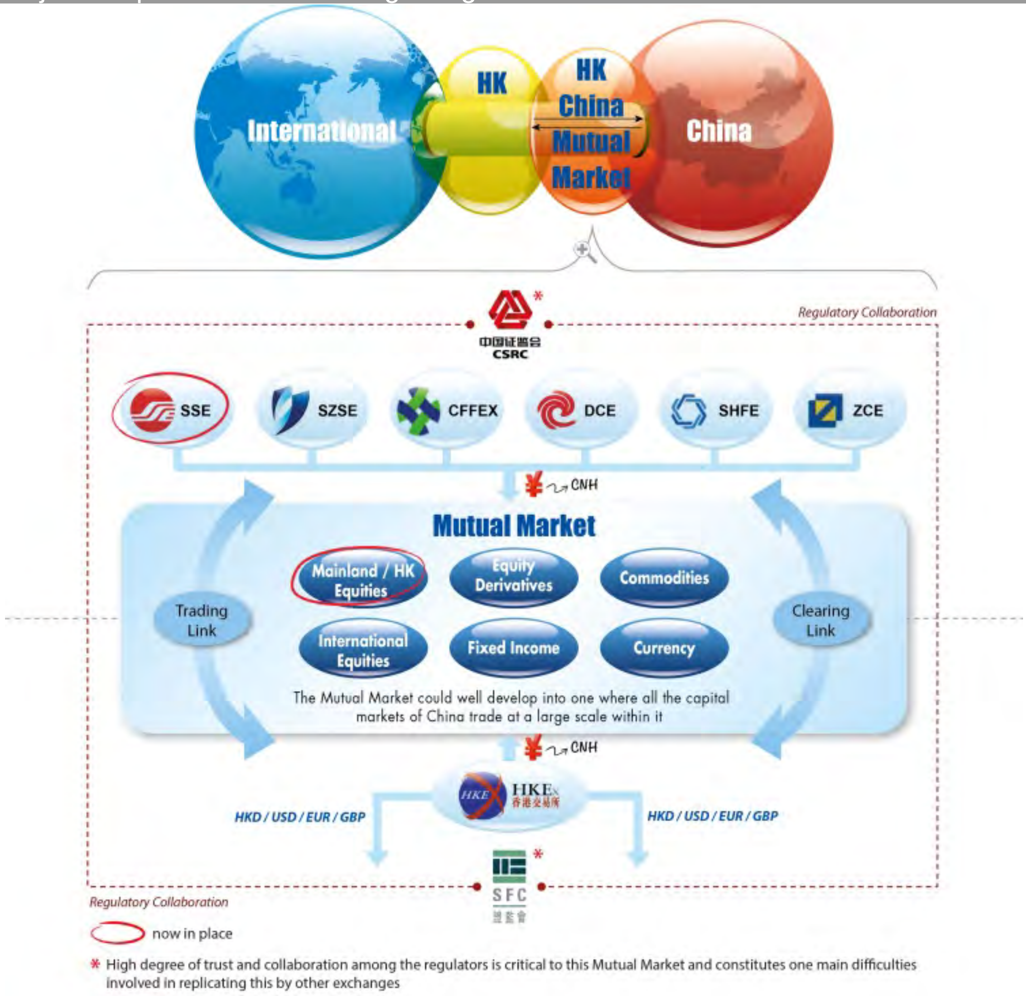
Our base case assumes over 80-90% of China's financial sector will remain on-shore in the foreseeable future. However, given the size of China's financial sector, 5-10% of its financial sector offshore could already mean tremendous opportunities for a small city like Hong Kong.

Hong Kong's special role in the Hong Kong-China Mutual Market



Source: Daiwa

Major components of the Hong Kong-China mutual market



Source: HKEx, Daiwa

Our view is that the market may have yet to fully grasp the impact this might have on the Hong Kong office sector. In any case, we have observed that in Shanghai, Beijing and many other cities in China, local companies have begun to account for a rising proportion of demand for new Grade-A office buildings. And that such demand will flow down to Hong Kong sooner or later. Further, given the current vacancy and supply situation in the Hong Kong Grade-A office market, incremental demand from probably just 50-100 companies renting 2,000-5,000 sq ft each would probably be enough to exert upward pressure on office rents in Hong Kong.

More importantly, if this analysis is valid, then the Hong Kong office market has actually started its next chapter, rather than being at a cyclical peak. It is stronger than it appears.

4. Swire Properties is in a good position to ride the Hong Kong office market

Regardless, our read is that Swire Properties is actually in a very good position to take advantage of the opportunities that we expect to see emerging in the Hong Kong office market in the coming years.

Of course, we understand that investors typically see the Hong Kong office sector as one that is either Central or the whole concept of decentralisation. While acknowledging that these are important themes in the sector, we don't think they are sufficient in capturing the essence of the developments taking place in the Hong Kong Grade A office market at this point.

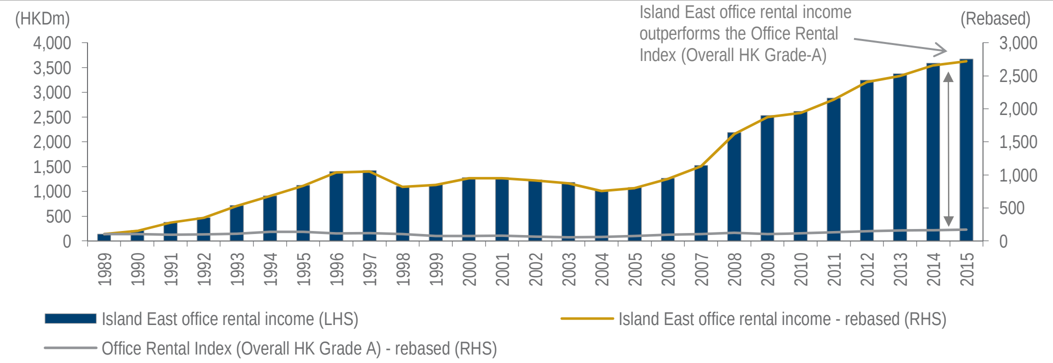
Our view is that the decentralisation trend in Hong Kong – in the sense of corporations continuing to look for office space outside of Central to achieve better value for money for the office rent bill – has to and will continue. However, this doesn't mean that the Central office market is in decline or facing problems. In fact it is expanding. Indeed, we would see the decentralisation trend as symbolising that office occupiers in Hong Kong have been actively looking for ways to optimise their office locations.

Our view is that this situation is healthy and reflects that Central office space is in demand, and that this demand is greater than what the Central area can accommodate. Hence, this will continue to drive some corporations previously located in Central to look for space in other locations and drive office landlords in other districts to improve their buildings so that they can accommodate the demand outflow from Central.

We expect such a trend to continue and likely drive a continuous upgrade in Hong Kong’s other office districts. We believe that the Hong Kong office market has been characterised by a lot of relocation activity over the past few years and we expect this trend to continue.

However, when it gets down to the nitty gritty, Taikoo Place is probably not the first choice for corporations pondering whether to leave Central. For those planning to leave IFC, Pacific Place (including Three Pacific Place) would probably be a credible alternative (ING recently decided to move from IFC to Three Pacific Place). Also, for those looking for even cheaper rents, Causeway Bay is likely to be first on the list before Island East.

Swire Properties: rental income from Island East offices vs. Hong Kong Grade-A offices



Source: CEIC, Company, Daiwa

And we do consider Causeway Bay to be in a very good position to benefit from the outflow of tenants from Central. However, the total stock of Grade-A office space in Causeway Bay is limited (we estimate the GFA to be less than 5m sq ft and there is very limited new Grade-A office supply in Causeway Bay – only from Lee Gardens Three).

Given the situation in Causeway Bay, we would expect that some tenants previously located in Central might consider Island East (Prudential is one example of a corporation moving from Exchange Square in Central to Island East). Meanwhile, some of them might prefer to pay more rent to secure office space in Causeway Bay, which would lead to some tenants currently in Causeway Bay being kicked out and maybe opting to move to Island East instead. Either way, we expect Island East to benefit.

Meanwhile, such a trend is likely to be reinforced by transport infrastructure developments such as the completion of the Wan Chai Bypass and Island Eastern Corridor Link by about 2018, which will cut the time it takes to travel to Central from Island East to less than 10 minutes by car.

Wanchai Bypass and the Island Eastern Corridor Link

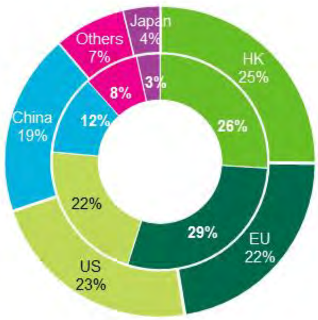
Source: HKSAR Government

In our opinion, this trend is a very important one. While many investors seem to have focused on the competitive threat that Kowloon East may pose to Island East, our read is that the benefits Island East will get from the outflow of tenants from Central is a development that should not be overlooked.

We also think that while many investors seem to have the perception that Swire Properties' portfolio is unlikely to benefit a lot from China-company demand for offices in Hong Kong, our view is that it is not necessary for many China companies to move to Pacific Place and Taikoo Place for the company to see some benefit.

For as long as the incremental PRC-company office demand results in some Central tenants needing to move, those landlords that can offer alternatives should benefit. Our view is that many multinationals may no longer choose to pay the rents asked in Central and that Pacific Place and Taikoo Place are credible alternatives. In the meantime, we recognise that some China companies are showing a preference for Pacific Place. Hence, whether directly or indirectly, we think Swire Properties will benefit from the overall rise in demand and improved outlook of the Hong Kong office sector.

Footprint growth of Mainland China companies in Greater Central



Source: Source: CBRE Research
**Note: based on 25 key Grade-A office buildings in Central, Admiralty, Sheung Wan*

5. Swire Properties could even benefit from the improved outlook for the office investment market

Another aspect that may have been overlooked by investors is that Swire Properties might not only benefit from the improved outlook for the Hong Kong office segment in terms of higher rents in Pacific Place and Taikoo Place. It has actually been, and still is, the largest investor in the Hong Kong office sector in recent years and we expect it to see the largest expansion vs. peers in leased office area over 2017-21.

Moreover, the company now has 2 office projects under construction in the non-traditional core office areas in Hong Kong. One is in Kowloon East; and the other in Wong Chuk Hang. Hence, if rent levels in these non-traditional Grade-A office areas do rise, Swire Properties would stand to benefit as it also has 2 new developments in this area. Moreover, to the extent that Swire Properties does not consider Kowloon East or Wong Chuk Hang core locations for its office properties, there is a chance that it could still monetise the value of its offices in these areas if the sales offer prices that are good enough. Indeed, Swire Properties could also benefit from the strength of the Hong Kong office market, by developing more offices in these emerging office districts, which could be used as long-term investments but also disposed of when the price is right.

When Swire Properties first invested in offices in Kowloon East and Wong Chuk Hang, these 2 areas were generally seen as unproven areas for Grade-A offices. As the largest office landlord in Hong Kong, we believe Swire Properties is in a stronger position to lease its office space in these districts, which could put it in a stronger competitive position when bidding for such office sites.

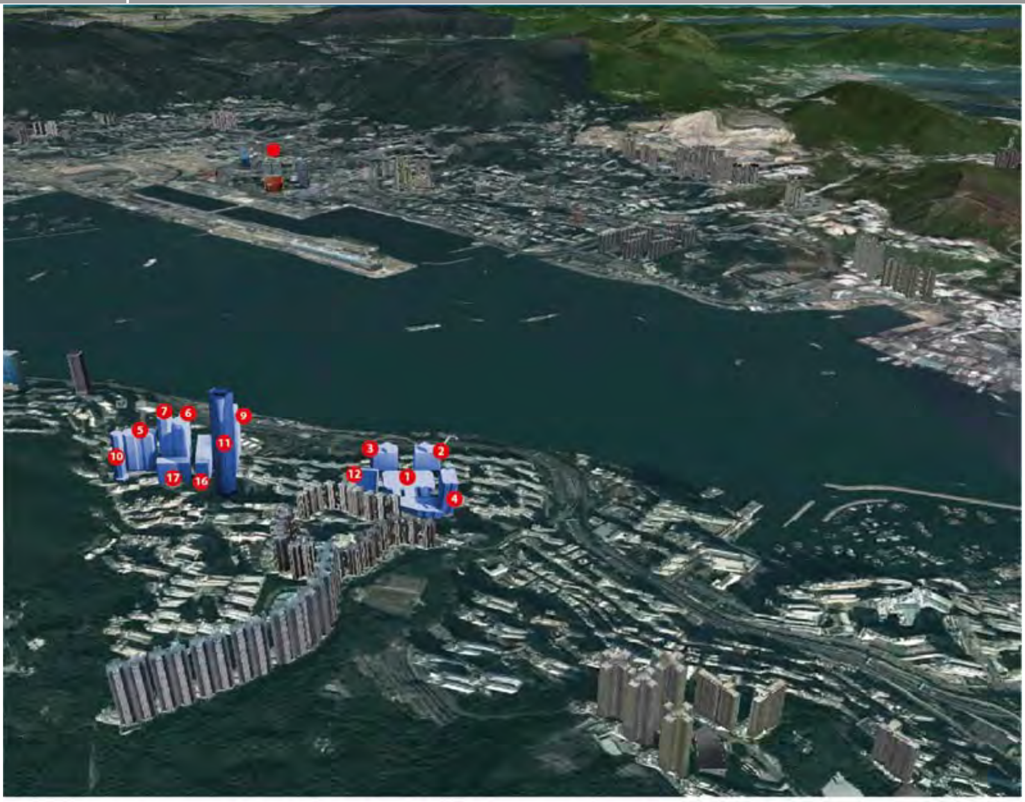
In the meantime, when good prices are offered for office properties in these districts, Swire Properties might consider selling its non-core assets, which could mean that it will use the proceeds from the sale of its office sites in these emerging districts to replenish its luxury residential landbank in Hong Kong, which will soon start to deplete.

Until 2013, there was no depth to the office sales market. However, in recent years, Wheelock has proven that there is a sales market for en-bloc office buildings in Hong Kong. Hence, we think that offices in the emerging office districts (either for sale for capital gains or long-term rentals) could be another way for Swire Properties to benefit from the current robust office market in Hong Kong. However, this may not yet have been generally recognised by the market.

The five key office districts in Hong Kong

Source: Company, Daiwa

Swire Properties: initial foothold in Kowloon East



● Swire Properties' commercial site at junction of Wang Chiu Road and Lam Lee Street

Source: Daiwa

Swire Properties: quarterly KPIs (office properties in Hong Kong)

	2012	2013	2014	1Q15	1H15	9M15	2015	1Q16	1H16
HONG KONG									
Pacific Place offices									
Occupancy (period end)	97%	91%	94%	94%	98%	99%	100%	98%	98%
New and renewed area let (sq ft)	215,720	466,831	201,128	127,141	189,028	219,990	227,509	437,796	520,603
Reversion	+32%	+27%	+7%	-4%	-4%	-2%	-1%	+13%	+12%
Spot rents (period end, HKD/sq ft)	95-110	90-110	90-110	90-110	90-115	90-120	90-125	95-130	95-130
Cityplaza offices									
Occupancy (period end)	98%	97%	100%	99%	98%	99%	100%	100%	100%
New and renewed area let (sq ft)	191,928	286,030	284,955	203,299	207,525	212,204	216,014	136,508	216,702
Reversion	+30%	+53%	+25%	+19%	+17%	+16%	+15%	+10%	+9%
Spot rents (period end, HKD/sq ft)	low-mid 40s	low-mid 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s
Taikoo Place									
Occupancy (period end)	99%	99%	98%	99%	100%	99%	99%	99%	99%
New and renewed area let (sq ft)	571,226	429,664	545,464	66,799	181,487	251,129	301,198	322,473	390,865
Reversion	+29%	+48%	+27%	+12%	+11%	+11%	+10%	+17%	+16%
Spot rents (period end, HKD/sq ft)	low-mid 40s	low-mid 40s	low-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	mid-high 40s	low-high 40s
One Island East									
Occupancy (period end)	100%	100%	98%	98%	99%	99%	99%	100%	100%
New and renewed area let (sq ft)	na	67,415	171,117	195,212	238,536	243,448	243,448	258,783	288,352
Reversion	+51%	+85%	+14%	+8%	+8%	+8%	+8%	+32%	+30%
Spot rents (period end, HKD/sq ft)	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s	mid 50s -high 60s
Techno-centres									
Occupancy (period end)	100%	100%	100%	100%	100%	100%	100%	na	na
New and renewed area let (sq ft)	153,683	237,911	61,061	34,729	56,049	125,219	125,219	na	na
Reversion	+20%	+25%	+12%	-1%	+6%	+6%	+6%	na	na
Spot rents (period end, HKD/sq ft)	low-mid 20s	low-mid 20s	mid 20s	mid 20s	mid 20s	mid 20s	mid 20s	na	na

Source: Company, Daiwa

Question 5

Has the market overlooked Swire Properties’ China investments?

Q5: Has the market overlooked Swire Properties' China investments?

"No artist is ahead of its time. He is the time. It is just that others are behind the time."

- Martha Graham

"The most decisive mark of the prosperity of any country is the increase in the number of its inhabitants…."

- Adam Smith

The misconception
There seems to be a view in the stock market that the China commercial property sector will forever be characterised by oversupply, and hence the sector is one to be avoided. However, we contend that it is time for investors to start looking at the select few companies that have hit upon the right way to manage commercial property projects in Mainland China. We consider Swire Properties to be one of that select few. While some in the market argue the company was late in entering China and that a "foreign company" cannot do well in the China commercial property sector, we beg to differ. Our take is that Swire Properties' financial performance and KPIs in recent years indicate that the company is a credible and promising vehicle for investors to gain exposure to the China commercial property sector.

The China commercial property sector is beset with problems and challenges
That China has an oversupply of commercial properties in many cities is clear. In our view, many provincial governments in China do not yet have a full understanding of commercial property. They seem to care more about how their cities look on postcards and how their land sales revenue is looking than determining the size and type of commercial properties their cities need, and whether such sites are made available at the right time.

This is a recipe for oversupply and a difficult market environment. As it stands, there are just too many inexperienced players in the field and too many commercial sites that should not have been sold, much less designated for commercial usage.

That the China commercial property sector as a whole is facing oversupply and beset with problems is not in doubt. But that is not to say that all the office buildings and malls in China are simply not worth looking at.

The China Retail property sector

Source: Daiwa

But isn't prime commercial real estate a relatively safe way to play the rise of a populous and mega-sized economy like China?
We believe that urbanisation is an irresistible and irreversible trend in China — one that should be underpinned by its high-speed rail system, which arguably ranks as one of the most advanced and efficient rail systems in the world. This trend is likely to see hundreds of millions of people migrate to China's major cities over the next few decades. Such a migration is unprecedented in human history, and hence history does not provide any guide as to the full consequences of this process. Our view is that the land value of prime sites in the city centres of major cities must go up considerably over time.

In any case, it is safe to assume that many of China's cities will see a multi-million-person expansion in their populations. Although China already has some of the largest cities in the world by population, these cities' share of the country's 1.3bn population looks modest (Beijing and Shanghai have less than 3% of the total population, whereas London accounts more than 10% and Tokyo and Seoul even greater proportions). As such, we think it is entirely conceivable that, in the future, the populations of Shanghai and Beijing will surpass 40m and China will have more than 10 cities with populations in excess of 10m (vs. about 5 today).

Given the size of China's domestic population, and that the country's bank deposits and M2 currently stand at USD20tn and USD22tn, respectively (both twice the equivalent figures for the US), it is entirely possible there could be some industries and services that survive and prosper simply by having a sufficient base of domestic demand.

In other words, even if all of China's industries are not competitive in international markets, the country should still have a sizeable domestic corporate sector serving the domestic market. Under this kind of broad-picture scenario, it would seem churlish, not to mention risky, for investors to write off completely the potential of all commercial property assets in China. After all, history suggests that one way for investors to play the rise of a populous and mega-sized economy is through its prime commercial real estate. We can't see any reason why China would be an exception to this rule.

China should have at least some office buildings that can deliver returns..
While many provincial governments are likely to keep rolling out plans for more CBDs, and the geographical size of many cities in China will continue to expand, the land in the current city centres of major Mainland cities is somewhat finite and urban renewal projects in major Chinese cities are likely to be increasingly difficult and costly.

In Shanghai and Beijing, after over a decade of relative chaos, we are starting to see a structure emerge in these cities' commercial property landscapes. Indeed, a few districts — including Nanjing Road West, Hua Ha Road and Lujiazui in Shanghai, and Chaoyang in Beijing) — are showing signs of being able to mature into commercial hubs that can sustain ecosystems of their own, in our view.

We note that the construction cost for commercial property in China is not high, certainly not compared with Hong Kong and other major international cities. We estimate that a construction cost of CNY10,000/sq m (about USD120/sq ft) is enough for a China developer that is not especially demanding in terms of quality. As such, for an office building with a GFA of 1m sq ft, having about 30 companies that can rent 20,000 sq ft or more and pay USD3/sq ft/month (CNY220/sq m) or more would be enough to generate a decent return (over a 15% gross yield on cost), as long as the developer can keep land costs under control.

Similarly, for a mall with a GFA of 1m sq ft, having just 15,000 tickets of CNY300 each every day would be enough for the mall to generate a decent return to the developers (over a 15% gross yield on cost), again assuming it can keep land costs under control.

Daiwa Capital Markets

Matrix on achieved tenant sales in malls

Avg. value per purchase (HKD)	Avg. no. of purchases per day									
	5,000	10,000	15,000	20,000	25,000	30,000	35,000	40,000	45,000	50,000
200	0.4bn	0.7bn	1.1bn	1.5bn	1.8bn	2.2bn	2.5bn	2.9bn	3.3bn	3.6bn
300	0.5bn	1.1bn	1.6bn	2.2bn	2.7bn	3.3bn	3.8bn	4.4bn	4.9bn	5.4bn
400	0.7bn	1.5bn	2.2bn	2.9bn	3.6bn	4.4bn	5.1bn	5.8bn	6.5bn	7.3bn
500	0.9bn	1.8bn	2.7bn	3.6bn	4.5bn	5.4bn	6.4bn	7.3bn	8.2bn	9.1bn
600	1.1bn	2.2bn	3.3bn	4.4bn	5.4bn	6.5bn	7.6bn	8.7bn	9.8bn	10.9bn
700	1.3bn	2.5bn	3.8bn	5.1bn	6.4bn	7.6bn	8.9bn	10.2bn	11.4bn	12.7bn
800	1.5bn	2.9bn	4.4bn	5.8bn	7.3bn	8.7bn	10.2bn	11.6bn	13.1bn	14.5bn
900	1.6bn	3.3bn	4.9bn	6.5bn	8.2bn	9.8bn	11.4bn	13.1bn	14.7bn	16.3bn
1,000	1.8bn	3.6bn	5.4bn	7.3bn	9.1bn	10.9bn	12.7bn	14.5bn	16.3bn	18.2bn
1,200	2.2bn	4.4bn	6.5bn	8.7bn	10.9bn	13.1bn	15.2bn	17.4bn	19.6bn	21.8bn
1,400	2.5bn	5.1bn	7.6bn	10.2bn	12.7bn	15.2bn	17.8bn	20.3bn	22.9bn	25.4bn
1,600	2.9bn	5.8bn	8.7bn	11.6bn	14.5bn	17.4bn	20.3bn	23.2bn	26.1bn	29.0bn
1,800	3.3bn	6.5bn	9.8bn	13.1bn	16.3bn	19.6bn	22.9bn	26.1bn	29.4bn	32.7bn
2,000	3.6bn	7.3bn	10.9bn	14.5bn	18.2bn	21.8bn	25.4bn	29.0bn	32.7bn	36.3bn
2,200	4.0bn	8.0bn	12.0bn	16.0bn	20.0bn	24.0bn	28.0bn	31.9bn	35.9bn	39.9bn
2,400	4.4bn	8.7bn	13.1bn	17.4bn	21.8bn	26.1bn	30.5bn	34.8bn	39.2bn	43.6bn
2,600	4.7bn	9.4bn	14.2bn	18.9bn	23.6bn	28.3bn	33.0bn	37.8bn	42.5bn	47.2bn
2,800	5.1bn	10.2bn	15.2bn	20.3bn	25.4bn	30.5bn	35.6bn	40.7bn	45.7bn	50.8bn
3,000	5.4bn	10.9bn	16.3bn	21.8bn	27.2bn	32.7bn	38.1bn	43.6bn	49.0bn	54.5bn

Source: Daiwa

Achieving the benchmarks above is not going to be easy, especially with the rapid run-up that we have seen in land prices in major cities in the past 18 months. That said, we note that for land acquired in China in the 2000s or before, the land cost was much lower. Hence, for these projects, attaining the above thresholds after 1 to 2 leasing cycles is not unrealistic. Meanwhile, we can view the rapid rise in land prices in major Mainland cities in recent years as a kind of protection on returns from commercial property projects that were negotiated and commissioned in previous years.

In sum, notwithstanding the challenges facing the sector, there are at least some office buildings and malls in the country that can generate decent returns for investors. Given that China has 31 provinces and that many provinces have populations of more than 60m, we think it is safe to say that China should have at least 20 malls and 20 office buildings (out of thousands) that can deliver decent returns to developers.

Contrary to popular belief, the top end of the China commercial property sector is not yet too crowded, in our view. While China has many property companies whose supposed focus is on commercial real estate, not many focusing on developing and managing prime commercial real estate in the major cities have yet gained the confidence of international corporations and retailers. In fact, we reckon there are fewer than 10 such companies across the whole country.

We include Swire Properties in this select group, and in our view the company could even be considered among the top 3 players, if not the leading player altogether.

The trick is to find out where the genuine and sustainable demand lies

Granted, the China commercial property sector is a young industry in a state of flux, if not chaos. Every major player is in the process of learning and exploring, which makes it hard to single out the potential winners. The problem is compounded by the fact that China has changed dramatically in the past 10 years or so, which has led to wrenching change in many industries, including commercial property. In the commercial property space, we believe that one of the legacies of China’s rapid growth is the existence of unreal and unsustainable demand in both the retail and office property segments.

In this light, we believe that one way to play the China commercial property sector is to figure out where the genuine and sustainable demand lies, and then determine which player has the strategy and capabilities to harness such demand.

Contrary to popular belief, we think Swire Properties has found its way in China

In the realm of retail property, it is quite clear that a significant portion of luxury spending in China during 2009-13 was unreal and unsustainable. Indeed, we think it is fair to assume that ticket sizes of CNY100,000 or more are hard to sustain in any city in the world.

Swire Properties: China property portfolio

Source: Company, Daiwa

Swire Properties: expansion of China portfolio

			GFA (sq ft)				
Project	**Area**	**Year of completion**	**Office**	**Retail**	**Residential / Serviced Apt**	**Hotel (rooms)**	**Total**
Hui Fang	Guangzhou	2008	0	90,847	0	0	90,847
Taikoo Li Sanlitun	Beijing	2008	0	1,296,308	0	169,463 (99)	1,465,771
Taikoo Hui	Guangzhou	2011	1,731,766	1,472,730	51,517	584,184 (263)	3,840,197
INDIGO	Beijing	2012	595,464	939,493	0	358,269 (369)	1,893,226
Sino-Ocean Taikoo Li	Chengdu	2014	0	1,248,738	127,579	228,210 (100)	1,604,527
HKRI Taikoo Hui	Shanghai	2016	1,836,543	1,096,905	147,435	388,053 (200)	3,468,936
Dalian Port project	Dalian	2020E	0	952,968	2,223,592	0	3,176,560
Qiantan project	Pudong, Shanghai	2021E	0	1,334,725	0	0	1,334,725
Total			**4,163,773**	**8,432,714**	**2,550,123**	**1,728,179 (1,031)**	**16,874,789**

Source: Company, Daiwa estimates

Swire Properties: investments in China property

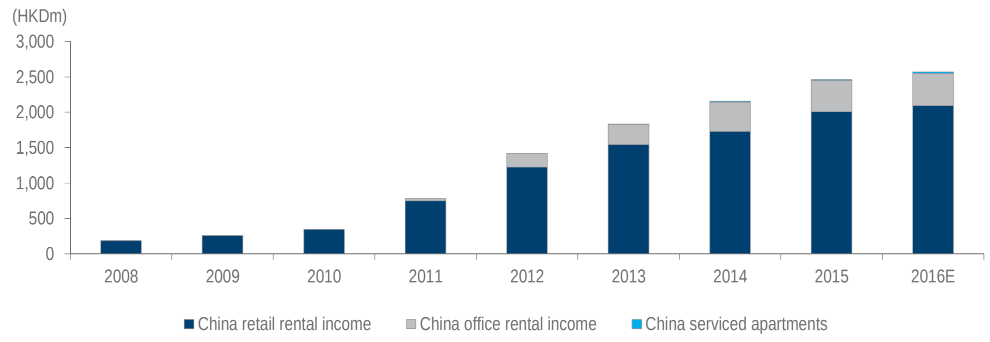
Date	Major events
2002	Acquired the land for Taikoo Hui
2006	Acquired a 50% stake in the Dazhongli project in Shanghai from HKR International
2007	Acquired 80% stake in Sanlitun Village, Beijing
2008	Formed a 50/50 joint-venture with Sino-Ocean to take a 50% stake in the INDIGO project in Beijing
	Opening of Sanlitun Village South and The Opposite House
2010	Opening of Sanlitun Village North
	Formed a 50/50 joint-venture with Sino-Ocean to acquire the Daci Temple site in Chengdu
2011	Opening of Taikoo Hui
	Opening of INDIGO's office tower, ONE INDIGO
Mar-12	Phased opening of the mall of INDIGO Beijing
Jan-13	Opening of Mandarin Oriental Guangzhou at Taikoo Hui
Apr-13	Renamed its mixed-use commercial property project in Beijing from "Beijing Sanlitun Village" to "Taikoo Li Sanlitun"
Aug-13	Sold 89% of Pinnacle One (office of the Daci Temple project) for CNY2.1bn
Jan-14	Signed a framework agreement with CITIC Real Estate and Dalian Port Real Estate to jointly develop (Swire will have a 50% stake) a project in the Zhongshan District of the Dalian city's CBD.
Feb-14	Acquired the remaining 20% stake in Taikoo Li Sanlitun from Gaw Capital Partners
Apr-15	Opening of the mall at its Daci Temple project "Sino-Ocean Taikoo Li" in Chengdu
Jul-15	Named its 50/50 JV project with HKR Int'l in Shanghai "HKRI Taikoo Hui", formerly known as the Dazhongli project
	Opening of The Temple House within Sino-Ocean Taikoo Li in Chengdu
	Signed a framework agreement with Shanghai Lujiazui Finance & Trade Zone Development Co Ltd to jointly develop (Swire will have a 50% stake) a retail project in Qiantan, Pudong New District in Shanghai

Source: Company, Daiwa

That said, we caution against going to the other extreme by overlooking the potential of genuine middle-class and luxury spending in China, which we think is real and sustainable in the country's major cities. Having surveyed the commercial property landscapes of over 20 cities in China, our view is that ticket sizes of CNY100-250 are well within the reach of the more well-to-do segments of the populace in these cities, as well as nearby areas. At the same time, this is the kind of spending that can have considerable volumes.

And for the top cities in China, alongside the growing volumes of ticket sizes in the CNY250-1,000 range, ticket sizes of CNY10,000 or more have shown they can sustain some volumes too. Mathematically, it only takes a few thousand tickets in each of the above categories to deliver annual sales of over CNY1.6bn (USD180m, or USD240 sales per sq ft per month based on a GFA of 1m sq ft and 0.5m sq ft of lettable floor area). This CNY1.6bn figure is the threshold that malls in China need to reach to start providing acceptable returns to developers, on our estimates. As a matter of fact, we have found a few malls in China with annual tenant sales in excess of CNY3bn.

Swire Properties: China rental income growth



Source: Company
Note: rental income includes contributions from JCEs and associates

As for office space, our read is that major multinationals seeking a presence in China have probably already established a presence in the country. Moreover, the home markets of many of these multinationals are facing macro uncertainties. As such, we believe that multinationals' demand for more office space in Mainland cities has not been strong in recent years, and we do not expect this to change any time soon.

That said, in some cities in China, there is a base of office demand from local, regional and national corporations that we consider to be both real and sustainable. After all, in terms of the total stock of Grade-A offices or even retail space, China does not yet appear to be in structural and severe oversupply territory.

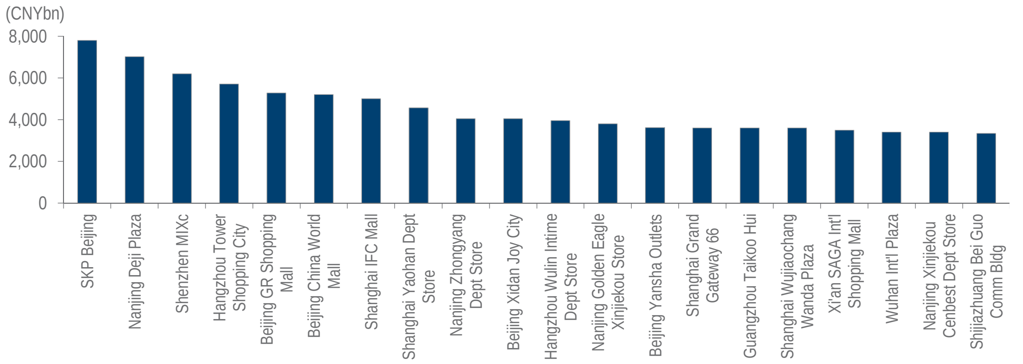
The heart of the problem in China commercial property lies in the fact that many of these segments have operating histories of a decade or less, and the bulk of the supply has come on stream in recent years (with more to come in the next few years). Worse still, there has often been little systematic planning at the local government level when these sites have been sold, and so the situation today appears to be messy and chaotic.

That said, if China can maintain its GDP growth at 5% or more in the years ahead, and given that many of these cities are likely to end up with populations of 10m or more, the current stock of commercial property in many cities (completed and under construction) is not out of kilter, in our view.

In short, we believe the issues facing China commercial property come down to a digestion problem, as well as a question as to whether the country can fix — and if so how quickly — the structural problems in its land supply mechanism. These structural problems are not conducive to responsible and sensible land supply decisions and city planning over the long term.

That said, our view is that the physical size and the rising cost of urban renewals in many cities in China will help to ensure that, amid the apparent chaos in China's commercial property sector, a few districts gradually establish the kind of ecosystems that are conducive to these areas remaining credible commercial hubs in the long term. Herein lies one of the major opportunities in the China commercial property sector.

Tenant sales in various major retail properties in China in 2015



Property	Names in Chinese
SKP Beijing	北京 SKP（原新光天地）
Nanjing Deji Plaza	南京德基广场
Shenzhen MIXc	深圳万象城
Hangzhou Tower Shopping City	杭州大厦购物城
Beijing GR Shopping Mall	北京世纪金源购物中心
Beijing China World Mall	北京国贸商城
Shanghai IFC Mall	上海 IFC 国际金融中心
Shanghai Yaohan Dept Store	上海第一八佰伴
Nanjing Zhongyang Dept Store	南京中央商场
Beijing Xidan Joy City	北京西单大悦城
Hangzhou Wulin Intime Dept Store	杭州武林银泰总店
Nanjing Golden Eagle Xinjiekou Store	南京金鹰国际购物中心新街口店
Beijing Yansha Outlets	北京燕莎奥特莱斯
Shanghai Grand Gateway 66	上海港汇恒隆广场
Guangzhou Taikoo Hui	广州太古汇
Shanghai Wujiaochang Wanda Plaza	上海五角场万达广场
Xi'an SAGA Int'l Shopping Mall	西安赛格国际购物中心
Wuhan Int'l Plaza	武汉国际广场
Nanjing Xinjiekou Cenbest Dept Store	南京新街口百货
Shijiazhuang Bei Guo Comm Bldg	石家莊北国商城

Source: linkshop.com.cn,Google, Daiwa

Granted, Swire Properties was not one of the first entrants to the China market, and by the time it did enter in Beijing in 2008, the first wave of major demand for office and retail property space had already been met by other property assets.

But this might have been a blessing in disguise, in that Swire Properties was compelled to focus on tapping the genuine and sustainable demand from the get-go. Making money from China isn't always easy, and during 2002-10 Swire Properties struggled when exploring ways to execute its China projects.

Since 2013, however, the efforts it has made to nurture its China commercial property assets look to be bearing fruit, suggesting the company has found a way to manage prime commercial properties in China. This progress is borne out by a notable rise in the gross rental income from effectively all of the company's properties in the Mainland, as well as the fact that the retail sales in its malls in China have kept growing (broadly speaking by 10-25% in 2015) despite the challenging environment. Moreover, there are signs of its progress across the board, including Beijing, Guangzhou and, most recently Chengdu.

We believe that most of Swire Properties' projects in China have become recognised as landmarks, whether in Beijing, Guangzhou or Chengdu. Perhaps the one exception is Indigo in Beijing, which was Swire Properties' first experiment in the realm of decentralised areas in China. That said, we believe Indigo is a well-recognised landmark in its district.

We think the image and recognition Swire Properties has established in China is especially important, because our view is that Swire Properties' business model is essentially about the transformation of a location. We therefore see it as promising that Swire Properties' China projects have become landmarks in their respective cities, since they should command a kind of "magnetic effect" for shoppers, tenants and perhaps provincial governments as well.

Indeed, these effects are now in evidence, with some major retailers opting to partner with Swire Properties wherever it goes in China. What is most important, however, is that Swire Properties' track record in China seems to have attracted the attention of some provincial governments, many of which are starting to explore co-operation opportunities with Swire Properties, potentially with a view to having projects similar to Sino Ocean Taikoo Li (see page 59 for more details of this property) in the years to come.

We see the group's potential involvement in the Dalian and Qiantan projects (Swire Properties was invited to be a partner in both projects, and framework agreements have been signed for both) as evidence that its way of doing commercial property projects in China is gaining recognition and acceptance by government bodies and industry peers alike.

In the following section, we take a project-by-project look at the progress being made by Swire Properties in China.

Swire Properties: gross rental income from China

(HKDm)	2008	2009	2010	2011	2012	2013	2014	2015	2016E
Taikoo Hui, Guangzhou	19	19	19	322	903	1,097	1,232	1,322	1,332
Taikoo Li Sanlitun, Beijing	163	239	325	457	469	526	665	692	701
INDIGO, Beijing	-	-	-	-	47	214	256	272	278
Sino-Ocean Taikoo Li, Chengdu	-	-	-	-	-	-	-	177	258
HKRI Taikoo Hui, Shanghai	-	-	-	-	-	-	-	-	-
Dalian port project	-	-	-	-	-	-	-	-	-
	181	258	344	779	1,419	1,837	2,153	2,463	2,569

Source: Company, Daiwa estimates
*Note: *rental income includes contributions from JCEs and associates*

Taikoo Li Sanlitun looks set to become one of the major retail hubs in Beijing
Judging by its population, wealth and other attributes, Beijing has the credentials to be a mega-sized retail hub in China. However, it appears to us that this process will take quite a while to unfold.

In our view, there are many constraints in terms of finding an area in Beijing that can go on to become the city's dominant retail hub. First, it does not seem to us that the explosive growth that this large city has undergone in recent years has been accompanied by sophisticated city planning. Hence, traffic congestion is commonplace. While commuting from one point of Hong Kong to another would take no more than an hour, the equivalent journey in Beijing could take 4 hours or more. In short, it appears challenging, if not impossible, to find an area in Beijing where the retail catchment area could encompass the entire city, as well as the population in the vicinity.

That said, Beijing as a whole clearly has consumption power — the Shinko Place in Beijing has been the No. 1 in China by tenant sales for many years (its CNY7bn-plus in reported tenant sales in 2015 is over 4x our assumed critical mass level for tenant sales for major malls in China).

Against this backdrop, we believe Beijing's retail property market in the future is likely to be characterised by multi-clusters, and Sanlitun has more or less established its position as one of these clusters. Arguably the main question now is how much further it can go from the current level. Currently, the No. 1 retail property assets in China register annual sales of about HKD8bn, while Harbour City in Kowloon alone has tenant sales in excess of HKD33bn. As such, we think tenant sales in Mainland malls have ample scope to improve further.

As for Taikoo Li Sanlitun, we think it has come a long way from its early days, carving out an identity as the place to go in Beijing for trendy and lifestyle consumer items. Its progress has doubtless been helped by the fact it is located within the city's Embassy area and right next to the city's bar and nightlife hub.

Taikoo Li Sanlitun, Beijing

Source: Company

In our opinion, the South Wing of Taikoo Li Sanlitun appears to have already entered a kind of virtuous cycle in the development of the mall, with rising visitor traffic and steadily growing tenant sales attracting more quality tenants seeking space there. Although the North Wing of Sanlitun, which focuses more on the high-end or luxury segment, is not as well developed as the South Wing, we believe the strong performance of the South Wing should bring positive spill over effects for the North Wing over time.

One hurdle facing Sanlitun is that it is not yet directly connected to the subway system. Nor are there lots of quality office buildings nearby which can feed the mall with a larger pool of captive customers. However, we expect the situation to improve gradually, since current plans call for the area to have a subway line nearby, while there are likely to be more upmarket office and residential developments in the vicinity in the years to come.

In our view, these developments will reinforce the potential and rental income prospects of Taikoo Li Sanlitun at only limited incremental operating cost, which underlines the merits of Swire Properties’ retail-led mixed development model. In sum, we consider Taikoo Li Sanlitun to be in good shape to become one of the major retail hubs in Beijing.

Indigo is on track to become a regional retail hub

In some respects Indigo is a departure from Swire Properties’ standard mixed commercial property project in China, because it is not located in an existing prime area. Instead, the mall is in a new location and is targeting people within the area and its nearby environs, in contrast to a luxury mall, which seeks to appeal to people living throughout the city as well as in nearby areas.

In common with most retail projects in new locations, the response from tenants and shoppers to Indigo when it opened in 2012 was mixed. That said, Swire Properties has succeeded in beefing up the mall and the tenant sales figures from Indigo have grown robustly in recent years (albeit from a low base).

INDIGO, Beijing

Source: Company

In sum, while we do not expect Indigo to be landmark project in Beijing akin to Taikoo Li Sanlitun, we think it is significant for 2 reasons.

First, Indigo is an example of Swire Properties adapting its product to the local environment and shows that its business model also works for lower-grade products and in new locations. We see this as a reflection of the group's retail management expertise and its ability to develop and manage mass-market malls. Indigo is the group's second retail project in Beijing, and we would not be surprised to see the group adopt a similar strategy in other cities and eventually roll out 2 or more retail property projects in Mainland cities in which it believes it has the requisite experience and human resources.

Second, we believe that Indigo could be a showcase for what Swire Properties can do in its China projects over time. We note that Indigo is located in a new area surrounded by many sites, which gives it the potential to scale up its established presence in the area.

In Hong Kong, Swire Properties' business model for Pacific Place was to use retail to help establish the area (in this case, Admiralty), and then offices are the property segment through which it realises the largest expansion in scale and achieved rent. The circumstances in China and Hong Kong are not the same, of course. But our take is that additional retail space, allied with high-end residential, could be more important in the China context. Hence, we see Indigo as a showcase for the possibilities ahead for Swire Properties in Mainland China.

Guangzhou Taikoo Hui is establishing itself as a landmark for the city despite keen competition

We view Guangzhou Taikoo Hui as an example of how Swire Properties can build a landmark in a Mainland city despite the area not having being designated by the state as the official CBD. While it is fair to say that Taikoo Hui faced challenges in its early years, it has been able to achieve steady growth in tenant sales in recent years and is now regarded by some observers as a signature property project in the city. This progress has been made despite the nationwide weakness in luxury spending and even though Guangzhou Taikoo Hui is not located in the Government-designated future CBD (Pearl River New Town area).

In our opinion, as a CBD, the Pearl River New Town is not especially well planned and the connectivity among the various buildings in the area is lacking. As such, we see the progress that Swire Properties has made with Guangzhou Taikoo Hui project as a sign of the company's strength in retail property management and as supporting our thesis that well-managed, large-scale mixed developments can create their own markets over time.

Taikoo Hui, Guangzhou

Source: Company

Hence, despite all the new supply of office and retail space in Guangzhou and the CBD area, we believe Taikoo Hui is well placed to retain its position as the top mall in the city. The luxury brands seem to agree, as the mall already features most of the world's major luxury names.

In addition, the office portion of Taikoo Hui looks to have held up well despite the oversupply of offices in the Pearl River New Town. We believe the mixed-development nature of Taikoo Hui differentiates it from other new buildings as well as supporting higher levels of tenant stickiness, which we think underlines the value of having well-executed, large-scale mixed developments.

Chengdu: looks to be doing well

If Guangzhou Taikoo Hui can be considered a standard Swire Properties project, then Sino Ocean Taikoo Li is probably the boldest departure from the norm. While technically a mall, it has many pedestrian areas and there are several retail blocks covering the entire area, which seems to be a hybrid of high streets and traditional malls. Although Taikoo Li Sanlitun in Beijing is probably the forerunner for this type of retail property in China, we believe it was a brave move by Swire Properties to put this innovative concept into practice. After the experience of Taikoo Li Sanlitun and Sino Ocean Taikoo Li, Swire Properties would probably regard "Li" as one of its product lines, which we see as another innovation in the retail property sector.

But we think Sino Ocean Taikoo Li is not only about innovation in retail formats. It is also probably the first experiment in China that seeks to blend retail with tourism and culture. Sino Ocean Taikoo Li is on a site that features a 1,000-year-old temple, and Swire has carefully mixed the project such that it has become a landmark in Chengdu city for shoppers, tourists, and people seeking art and culture.

Importantly, we believe the mall has become popular among the people of Chengdu and attracted the attention of provincial governments keen to have similar projects in their cities.

In any case, as a retail property project, Taikoo Li Chengdu looks to be on an encouraging track. We see the Chuanxi Road cluster in which the development is located as a promising retail cluster; local media report that before the opening of Wharf's IFS and Swire Properties' Sino-Ocean Taikoo Li Chengdu, the Chuanxi Road cluster generated retail sales of over CNY10bn pa. In conclusion, we see Sino Ocean Taikoo Li as one of the more promising large-scale mixed development projects in the city.

Swire Properties: Sino-Ocean Taikoo Li Chengdu

Source: Company

Shanghai: targeting trendy and lifestyle consumers
While Swire Properties’ HKRI Taikoo Hui project in Shanghai Puxi will not open until 2017, we understand the mall will not be exclusively high end; rather, it will target high-end, contemporary, and up-and-coming brands, which we think will help to differentiate it within the city. Of note, Starbucks looks set to have a flagship “experience-based” store in the property — larger even than the one in its home town of Seattle — that will give shoppers a chance to see how coffee is made and prepared.

Hence, while Shanghai appears to be well served in terms of luxury retail, we believe that HKRI Taikoo Hui could be a distinctive offering in the city’s retail property sector. We expect the project to mainly target Shanghai residents and to be a differentiated product.

HKRI Taikoo Hui, Shanghai

Source: Company

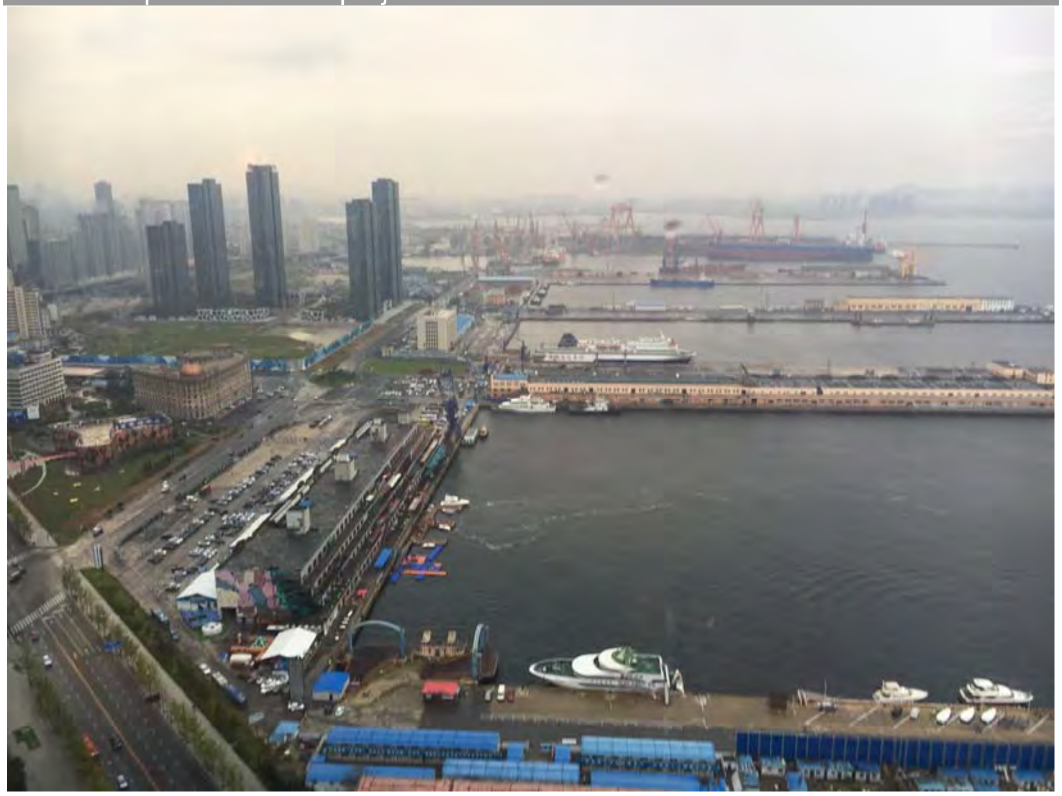
Overall, this looks to be the first of Swire Properties' malls to see what lifestyle and entertainment can bring to shopping malls in China. We see this project as the first major experiment in this direction, and hence we expect it to serve as a showcase for an alternative model for high-end malls.

Dalian and Qiantan: early days

We believe Swire Properties has gained some recognition among investors/property-market participants for its differentiated strategy in the China commercial property business. In turn, its potential involvement in projects in Qiantian and Dalian highlight the progress it has made with its existing China projects, in our opinion. In both cases, Swire Properties has been invited to be partner, which we think underlines a growing recognition of its track record in building landmark transformational mixed-development projects.

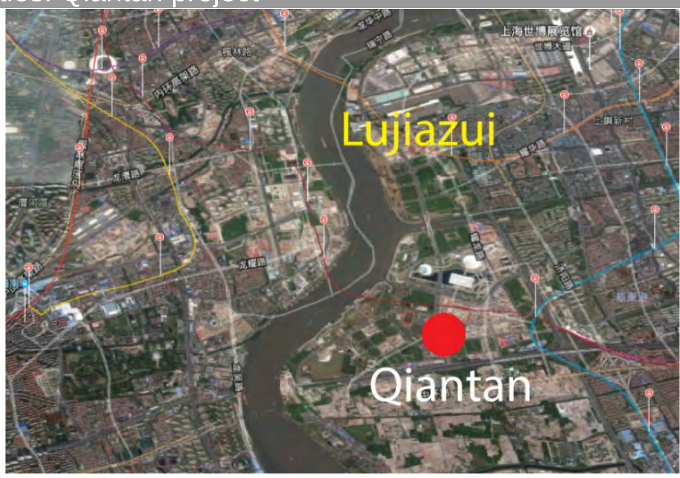
It is perhaps too early to talk about Dalian and Qiantan in detail, as to date only framework agreements have been signed. Still, these are important and strategic sites, and we think Swire Properties could gain access to more such opportunities over time.

Swire Properties: Dalian project



Source: Daiwa

Swire Properties: Qiantan project



Source: Daiwa, Google.com

Looking at the quarterly KPIs of Swire Properties, its China businesses are showing improving momentum, with all of them having recorded double-digit growth in tenant sales since 2013 despite the challenging retail environment in China. It is likewise encouraging to us that the improvement in tenant sales at Swire Properties' China malls seems to have been across the board, with Indigo in Beijing ramping up quickly from a low base and Taikoo Li Sanlitun and Taikoo Hui Mall in Guangzhou sustaining positive growth in tenant sales since 2012, and outperforming the industry.

Meanwhile, Swire Properties indicated in its most recent results announcement that all its malls in China had made a good start to 2016, with tenant sales growth of 4-113% YoY.

Overall, we contend that Swire Properties' presence in the China retail property market has gone from strength to strength in recent years, and it is now about to enter a new chapter. The market, however, has yet to recognise the progress it has been making.

Swire Properties: quarterly KPIs (office properties in China)

	2012	2013	2014	1Q15	1H15	9M15	2015	1Q16	1H16
CHINA									
Taikoo Hui Offices									
Occupancy (period end)	79%*	89%*	100%*	100%*	100%	100%	100%	100%	100%
New and renewed area let (sq m)	21,812	16,879	22,832	5,543	6,292	8,338	9,313	12,910	15,270
Reversion (%)	na	na	na	na	na	na	na	na	NA
Spot rents (period end, CNY/sq m)	mid-high 100s	mid-high 100s	mid-high 100s	mid-high 100s	mid-high 100s	mid-high 100s	mid-high 100s	mid100s-low200s	mid100s-low200s
ONE INDIGO									
Occupancy (period end)	95%*	97%*	100%*	99%*	97%*	100%*	92%*	91%*	91%*
New and renewed area let (sq m)	24,194	3,409	22,832	6,371	11,087	12,330	16,221	3,734	4,102
Reversion (%)	na	na	na	na	na	na	na	na	NA
Spot rents (period end, CNY/sq m)	low-mid 200s	low-mid 200s	mid-high 200s	mid-high 200s	mid-high 200s	mid-high 200s	mid-high 200s	mid-high 200s	mid-high 200s

Source: Company, Daiwa
*Note: *includes committed occupancy*

Swire Properties: quarterly KPIs (retail properties in China)

	2012	2013	2014	1Q15	1H15	9M15	2015	1Q16	1H16
CHINA									
Taikoo Hui Mall									
Occupancy (period end)	99%*	99%*	99%*	100%*	99%*	99%*	99%*	99%*	99%*
Retail sales growth	na	+24.9%	+11.0%	+19.8%	+20.7%	+19.5%	+16.2%	+4.9%	+4.0%
Taikoo Li Sanlitun									
Occupancy (period end)	94%*	94%*	95%	95%*	95%*	95%*	94%*	92%*	93%*
Retail sales growth	na	+17.0%	+18.8%	+4.5%	+6.5%	+4.4%	+3.3%	+5.4%	+3.7%
INDIGO Mall									
Occupancy (period end)	84%*	96%*	95%	92%*	94%*	97%*	97%*	98%*	99%*
Retail sales growth	na	na	+66.1%	+39.2%	+36.1%	+33.6%	+30.3%	+16.4%	+12.8%
Sino-Ocean Taikoo Li Chengdu									
Occupancy (period end)	na	na	na	88%*	87%*	86%*	88%*	89%*	91%*
Retail sales growth	na	na	na	na	na	na	na	+138.9%	+112.5%

Source: Company, Daiwa
*Note: *includes committed occupancy*

Question 6

What are the implications of Swire Properties’ Brickell City investment in Miami?

Q6: Is Miami an ignorable asset?

"A barren island with hardly a house upon it."

- Lord Palmerston

"Finance is based on trust."

- John Pierpont Morgan

The misconception
It may seem strange to many investors that Swire Properties has property interests in Miami, given Miami's distance from Hong Kong. It could be argued that the group's Brickell City project in Miami is another example of property companies venturing into new markets where they have no proven expertise or competitive edge.

The company may be better served, so the argument goes, by selling these assets and using the proceeds to concentrate on investments in more familiar markets. As the project does not account for a large portion of Swire Properties' NAV, some investors view the Miami assets as of little significance or even a liability to the share price as the project means allocating capital to new and unknown areas which may not generate meaningful returns to shareholders.

But an affordable investment at least
While we can see the merits of this argument, they should not be the only consideration. At the very least, we see the Miami project as an affordable investment for the company as it is likely to be self-funded from residential sales proceeds. We also believe the group has the expertise and management resources in place to execute such a project.

Drilling deeper down, we believe that the project has a greater significance beyond its contribution to rental income and NAV. In some ways the Brickell City project symbolises Swire Properties' unique business model and one may say it is a world-class property project by a world-class property company. However, the market's valuation of Swire Properties is currently below that of global peers.

A savvy investment in Miami…
Swire Properties is actually the second-oldest developer in Miami, with over 20 years of experience. It is also the leading developer for all residential units on the island adjacent to Brickell City. As such, we think Swire Properties' experience in Miami – and especially the Brickell City area – is as good as anyone else's.

Residential property projects developed by Swire Properties in Miami

Year	Project	Stake	GFA (m sq ft)
2001	Three Tequesta Point	100%	0.51
2002	Courts Brickell Key	100%	0.46
2004	Jade Residences	63%	0.65
2005	The Cartonell	100%	0.56
2008	ASIA	100%	0.32
2016	Reach, Brickell City Centre	100%	0.57
2016	Rise, Brickell City Centre	100%	0.57

Source: Company, Daiwa

Swire Properties: residential landbank in Miami and vicinity as of end-2015

Project	Location	Stake	GFA (sq ft)
South Brickell Key	Miami	100%	550,000
Fort Lauderdale site	Fort Lauderdale	75%	825,000
ASIA	Miami	100%	5,359*
Reach, Brickell City Centre	Miami	100%	567,000*
Rise, Brickell City Centre	Miami	100%	567,000*
Brickell City Centre - North Square site	Miami	100%	523,000
Total area			**3,037,359**

Source: Company, Daiwa
*Note: *saleable area*

The project has a sizeable residential component and we expect it to generate annual property sales proceeds in excess of USD200m over the next five years. Brickell should be self-financing as the annual cash flow from residential property sales should be enough to cover related expenses and the project is unlikely to pose a financial burden to the group.

… that has laid the foundation for future growth

We believe that Swire Properties secured a good entry point into Miami when it bought various plots of land in the Brickell City Centre following the Lehman crisis. This large pool of land should lay the foundation for Swire Properties' future growth in the Miami property market, in our view.

Miami has been gradually evolving to become the international financial centre for Latin America. While the city is part of the US, many of its people and corporations have close ties to Latin America. South America currently has a population of over 600m and is rich in natural resources. However, the continent does not yet have an international financial centre.

We draw parallels between Miami and Hong Kong in this regard. As Lord Palmerston's quote on Hong Kong in 1841 illustrates, cities may undergo transformations well beyond expectations when faced with unusual and exceptional circumstances.

Brickell City illustrates Swire's special business model

Swire Properties' decisive action in securing access to a large pool of land is what sets it apart from other peers, in our view. We believe the land pool is of sufficient size to have a significant transformational impact on the Brickell City area.

Brickell City Centre, Miami

Source: Company

We also note that the company has many years of experience in the execution of large-scale mixed development projects. This is quite a new concept in the North American property market. Indeed, not too many cities in the US are urbanised outside of New York, Chicago, San Francisco, Miami, etc. However, there is a global trend towards the emergence of more highly populated and urbanised cities. As such, the Brickell City project has attracted considerable attention from the local property industry.

The project is one of the largest – if not the largest – large-scale mixed property projects currently under development in the US. The ability to execute such an ambitious project has gained widespread recognition and confidence from various industry players, including global giants such as Simon Property and reputable luxury retailers such as Bal-Harbour Shops, both of which have taken minority stakes in the Brickell City mall.

Will stock-market perceptions converge with industry perspectives over time?

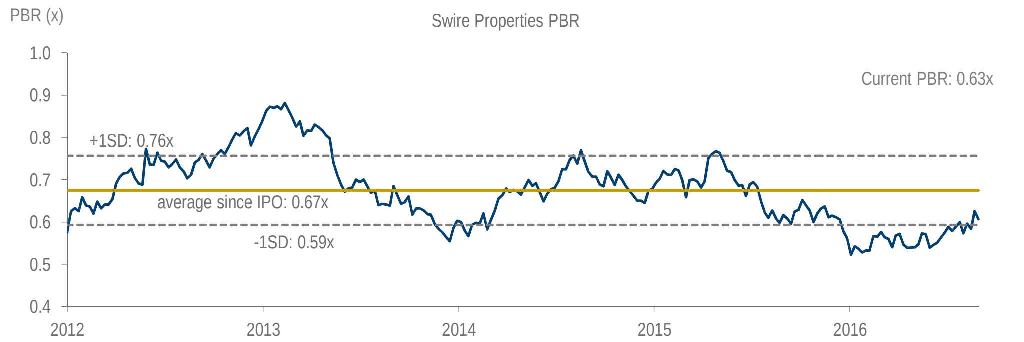
In many ways, the Brickell City project is a perfect illustration of Swire Properties' business model: patience in waiting for opportunities; seizing the opportunity once it arrives; working on it with focus and dedication which few can match; and finally reaping the rewards after a nurturing period.

In retrospect, we doubt whether Swire Properties expected Pacific Place and Taikoo Place to grow to become what they are today. The basic premise of its investment in these two locations was that the centre of Hong Kong would turn out to be too expensive for many industries and there would be a strong and sustainable market for locations which could serve as value-for-money alternatives.

This is probably just common sense. What sets Swire Properties apart is the execution of its vision and an unusual level of focus, quest for quality, readiness to innovate and adapt, and long-term view. History has shown that such a business model can generate strong returns to shareholders over time. We expect both Pacific Place and Taikoo Place to continue to grow and the group's model to be replicated in China, Miami and other cities.

Swire Properties' business model is based on a relatively long time horizon and hence may not suit every investor. However, it should work well for those looking for a continual rise in rental income and capital over an extended period.

Swire Properies: PBR



Source: Company, Datastream, Daiwa

Swire Properies: share price performance since listing

Source: Bloomberg

We believe the company's track record and quality of assets means it should be priced at a level similar to other global property peers. However, this is not the case today and we believe that the Hong Kong discount (the situation where Hong Kong property stocks have been trading at much larger discounts to NAV than their global peers – see our Hong Kong property sector report published on 1July [*First impressions can be deceiving: another look at the contrarian case]*) and various misconceptions about Swire Properties are to blame.

While narrowing the Hong Kong discount will not be an easy task, we believe that doing so is not beyond the reach of a few companies that:

1) can be increasingly seen as global players or excel in certain areas when compared with global peers, or

2) can continue to pay higher DPS, or

3) can continue to modernise their capital management, or

4) can build growing trust among global investors or show that the interests of family and external shareholders are reasonably aligned, or

5) can demonstrate that the company would be prepared to use its balance sheet and cash flow to back up its equity valuation when it chooses to do so,

or all of the above.

We believe that Swire Properties can narrow the Hong Kong discount as the market has a number of misconceptions about the company which we have tried to address in this piece. In sum, we believe the Brickell City project is already viewed by some as a world-class property project by a world class developer in a potentially up-and-coming world class city. However, this has not been reflected in its share price.

As development projects are tailored-made for specific locations and cities and require many specialists, one may argue that, in terms of quality, the projects created by Swire Properties are comparable to a sushi master's Omakase course. However, as seen in its share price, the company is now priced well below what one would expect from a sushi master's Omakase.

This mis-pricing will be corrected over time, in our view.

Swire Properties: NAV (2017E)

	Valuation				Blended
	Total (HKDm)	Per share (HKDm)	% share of total	Size (m sq ft)	psf price (HKD/sq ft)
HONG KONG					
Greater Pacific Place, Greater Central					
- Office	63,107	10.8	20.7%	2.4	26,154
- Retail	15,687	2.7	5.1%	0.7	21,233
- Residential/ serviced apartments	9,305	1.6	3.0%	0.4	21,000
- Hotel	4,976	0.9	1.6%	0.4	11,245
- Car parks	996	0.2	0.3%	-	-
	94,070	**16.1**	**30.8%**	**4.0**	**23,301**
Greater Taikoo Place, Island East		-			
- Office	93,690	16.0	30.7%	8.1	11,618
- Retail	18,989	3.2	6.2%	1.5	12,668
- Residential/ serviced apartments	752	0.1	0.2%	0.1	12,000
- Hotel	2,070	0.4	0.7%	0.2	10,369
- Car parks	5,936	1.0	1.9%	-	-
	121,436	**20.8**	**39.8%**	**9.8**	**12,359**
- Old building assets in Greater Pacific Place and Greater Taikoo Place*	7,077	1.2	2.3%	0.3	25,015
Investment properties in Greater Pacific Place and Greater Taikoo Place	**222,583**	**38.0**	**72.9%**	**14.1**	**15,735**
Other locations in HK					
Tung Chung	2,039	0.3	0.7%	0.3	7,520
Kowloon East	3,885	0.7	1.3%	0.6	7,000
Wong Chuk Hang	574	0.1	0.2%	0.2	3,000
Other investment properties in HK	6,395	1.1	2.1%	0.8	8,387
	12,893	**2.2**	**4.2%**	**1.8**	**7,244**
Investment properties in HK	**235,476**	**40.3**	**77.1%**	**15.9**	**14,786**
Development properties in HK	5,155	0.9	1.7%	0.8	6,137
HK property assets	**240,631**	**41.1**	**78.8%**	**16.8**	**14,353**
Mainland China**					
Beijing	16,657	2.8	5.5%	2.4	6,905
Guangzhou	27,845	4.8	9.1%	3.8	7,297
Chengdu	5,502	0.9	1.8%	0.8	6,974
Shanghai	7,544	1.3	2.5%	1.7	4,349
Dalian	-	-	-	-	-
China property assets	**57,547**	**9.8**	**18.9%**	**8.8**	**6,575**
Miami, UK and overseas					
Miami commercial property assets	4,933	0.8	1.6%	1.1	4,311
Miami residential property assets	1,321	0.2	0.4%	4.1	323
UK hotels	798	0.1	0.3%	0.2	3,824
	7,052	**1.21**	**2.3%**	**5.4**	**1,295**
Gross asset value	**305,230**	**52.2**	**100%**	**31.0**	**9,858**
Net debt	(35,200)	(6.0)			
NAV	**270,030**	**46.2**			

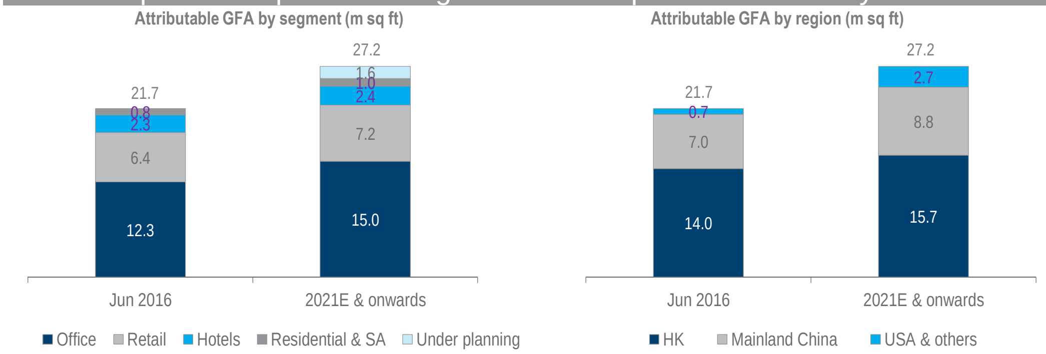
Source: Source: Daiwa
*Note: * Includes 82,909 sq ft of old building assets which can be identified and 0.2m sq ft GFA that we assume it already owns*
*** does not include projects in Dalian Port and Qiantan*

Swire Properties: NAV breakdown by usage (2017E)

	Valuation				Blended
	Total (HKDm)	Per share (HKDm)	% share of total	Size (m sq ft)	psf price (HKD/sq ft)
HONG KONG					
Greater Pacific Place and Greater Taikoo Place					
- Office	156,796	26.8	51.4%	10.5	14,966
- Retail	34,676	5.9	11.4%	2.2	15,496
- Residential/ serviced apartments	10,056	1.7	3.3%	0.5	19,885
- Hotel	7,046	1.2	2.3%	0.6	10,973
- Car parks	6,932	1.2	2.3%	-	-
- Old buildings	7,077	1.2	2.3%	0.3	25,015
	222,583	**38.0**	**72.9%**	**14.1**	**15,735**
Other locations in HK					
- Office	6,718	1.1	2.2%	1.4	4,778
- Retail	2,430	0.4	0.8%	0.3	8,507
- Residential/ serviced apartments	3,251	0.6	1.1%	0.04	80,000
- Hotel	352	0.1	0.1%	0.05	7,437
- Car parks	141	0.02	0.0%	-	-
- Old buildings	-	-	-	-	-
	12,893	**2.2**	**4.2%**	**1.8**	**7,244**
Investment properties in HK	235,476	40.3	77.1%	15.9	14,786
Development properties in HK	**5,155**	**0.9**	**1.7%**	**0.8**	**6,137**
HK property assets	**240,631**	**41.1**	**78.8%**	**16.8**	**14,353**
MAINLAND CHINA					
- Office	11,325	1.9	3.7%	3.0	3,781
- Retail	43,572	7.4	14.3%	4.4	9,910
- Residential/ serviced apartments	266	0.0	0.1%	0.1	2,928
- Hotel	2,082	0.4	0.7%	1.3	1,641
- Car parks	303	0.1	0.1%	-	-
	57,547	**9.8**	**18.9%**	**8.8**	**6,575**
Miami, UK and overseas					
- Office	640	0.1	0.2%	0.3	2,463
- Retail	1,702	0.3	0.6%	0.3	5,704
- Residential/ serviced apartments	1,653	0.2	0.5%	4.2	393
- Hotel	2,785	0.5	0.9%	0.7	4,063
- Car parks	271	0.0	0.1%	-	-
	7,052	**1.1**	**2.3%**	**5.4**	**1,295**
Gross asset value	**305,230**	**52.1**	**100%**	**31.0**	**9,858**
Net debt	(35,200)	(6.0)			
NAV	**270,030**	**46.2**			

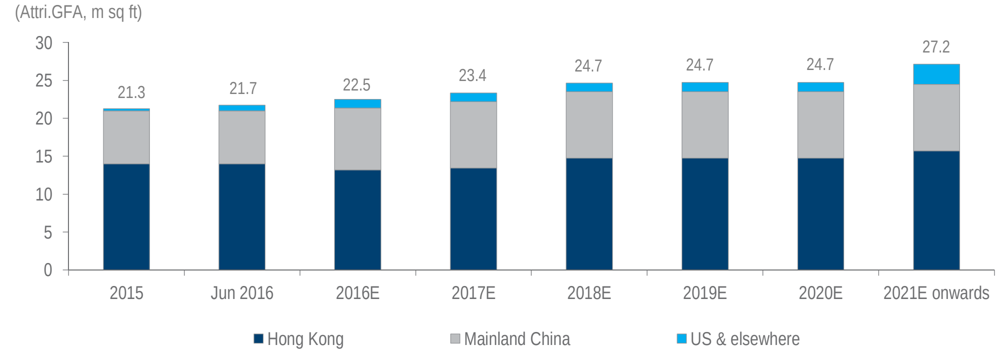
Source: Source: Daiwa

Swire Properties: expected change in GFA composition over five years



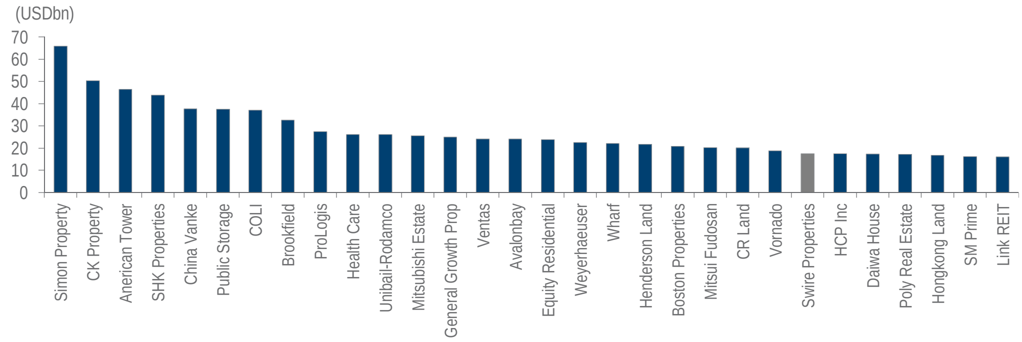
Source: Company
E – Swire guidance

Swire Properties: expected attributable GFA of completed investment properties



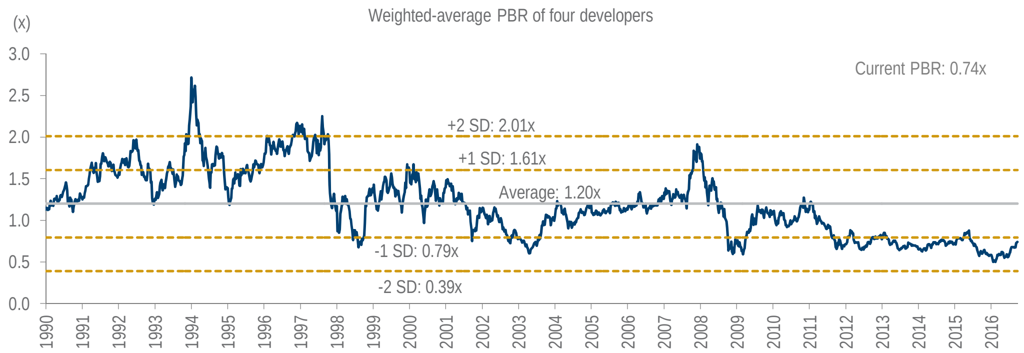
Source: Company
Note: As at 30 June 2016
E – Swire guidance

Global property stocks ranked by market capitalisation



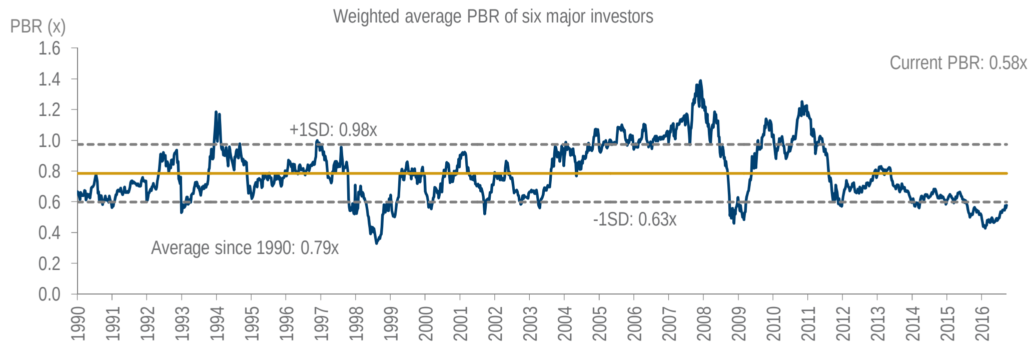
Source: Bloomberg, Daiwa
Note: as of 22 September 2016

Major Hong Kong developers: PBR



Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



Source: Companies, Datastream, Daiwa

Daiwa Capital Markets

Swire Properties (1972 HK)

Target price: **HKD32.30** (from HKD32.30)

Share price (22 Sep): **HKD23.50** | Up/downside: **+37.4%**

5 4 3 2 **1**

Buy
(unchanged)

Ready for another leap

- Its status as the largest player in HK office segment should strengthen
- China progress and potential still appear to have been overlooked
- Reaffirming Buy (1) rating and TP of HKD32.30

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What's new: We have examined Swire Properties' project pipeline, and looked at what we see as the market's main misconceptions (see the front section of this report). We conclude there is still a major mismatch between Swire Properties' actual corporate fundamentals and how the market perceives them, and expect the gradual removal of these misconceptions, among others, to help drive the share price and valuation in the next 6-24 months. In our view, the market's misconceptions have resulted in the themes summarised below not being sufficiently understood.

What's the impact: **Taikoo Place looks ready to make the leap to become the 2nd-largest commercial hub on HK Island outside Central**, a trend that should be helped by what we see as rising unit rents in Central and the building of One and Two Taikoo Place and Taikoo Square, which we expect to boost the attractiveness of Taikoo Place as a commercial hub.

Pacific Place is improving despite challenges faced by its mall. We also see Pacific Place emerging as another important single landlord property portfolio in Greater Central, a trend that is likely be helped by the continued expansion of Pacific Place into Wanchai South, as well as improving transport infrastructure directly linking Admiralty with more of Hong Kong. While Pacific Place mall is facing headwinds, we believe the challenges can be overcome and that the situation is manageable given that the office proportion of Pacific Place has expanded significantly.

Its China malls are showing promise. Tenant sales at Swire Properties' China malls have been growing since 2012, rising by 4-113% YoY in 1H16. We expect HKRI Taikoo Hui in Shanghai to start contributing by 2017, and this could be supplemented by its potential new projects in Dalian and Qiantan, Shanghai.

What we recommend: We believe Swire Properties' rental portfolio will reinforce its status as the largest player in the Hong Kong office market and strengthen its credentials as a major player in the China commercial property sector. We reaffirm our Buy (1) rating and 12-month TP of HKD32.30, based on a 30% discount applied to our end-2017E NAV of HKD46.20. Key risk: a sharper-than expected deterioration in the Hong Kong and China economies.

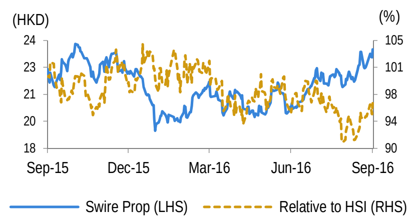
How we differ: We believe the market has unduly penalised Swire Properties because of the situation at Pacific Place mall and has neglected what we see as the promising prospects of its offices at Pacific Place and Taikoo Place, as well as its malls in China.

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	18.98-23.80
Market cap (USDbn)	17.72
3m avg daily turnover (USDm)	6.22
Shares outstanding (m)	5,850
Major shareholder	Swire Pacific (82.0%)

Financial summary (HKD)

Year to 31 Dec	16E	17E	18E
Revenue (m)	16,170	19,086	14,737
Operating profit (m)	9,248	10,137	9,991
Net profit (m)	7,410	8,310	8,350
Core EPS (fully-diluted)	1.267	1.420	1.427
EPS change (%)	4.7	12.1	0.5
Daiwa vs Cons. EPS (%)	1.7	4.3	11.7
PER (x)	18.6	16.5	16.5
Dividend yield (%)	3.2	3.5	3.6
DPS	0.760	0.820	0.850
PBR (x)	0.6	0.6	0.6
EV/EBITDA (x)	16.0	14.8	15.2
ROE (%)	3.4	3.8	3.7

Source: FactSet, Daiwa forecasts

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	60.0	57.7	59.6

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	10,778	11,276	11,841
Property trading	213	4,147	2,207	3,842	4,463	4,210	6,545	1,567
Other Revenue	811	890	1,052	1,089	1,268	1,182	1,265	1,329
Total Revenue	**9,581**	**14,052**	**12,936**	**15,387**	**16,447**	**16,170**	**19,086**	**14,737**
Other income	0	0	0	0	0	0	0	0
COGS	(2,334)	(3,770)	(3,531)	(5,176)	(5,781)	(5,307)	(7,308)	(3,074)
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**	**9,248**	**10,137**	**9,991**
Net-interest inc./(exp.)	(1,477)	(1,367)	(1,447)	(1,227)	(1,195)	(1,184)	(1,116)	(1,124)
Assoc/forex/extraord./others	890	453	500	505	412	579	658	862
Pre-tax profit	**5,409**	**8,273**	**7,240**	**8,222**	**8,309**	**8,643**	**9,679**	**9,729**
Tax	(770)	(1,199)	(769)	(892)	(1,209)	(1,210)	(1,344)	(1,353)
Min. int./pref. div./others	(267)	(142)	(111)	(178)	(22)	(23)	(25)	(26)
Net profit (reported)	**4,372**	**6,932**	**6,360**	**7,152**	**7,078**	**7,410**	**8,310**	**8,350**
Net profit (adjusted)	**4,372**	**6,932**	**6,360**	**7,152**	**7,078**	**7,410**	**8,310**	**8,350**
EPS (reported)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.267**	**1.420**	**1.427**
EPS (adjusted)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.267**	**1.420**	**1.427**
EPS (adjusted fully-diluted)(HKD)	**0.747**	**1.185**	**1.087**	**1.223**	**1.210**	**1.267**	**1.420**	**1.427**
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**	**9,248**	**10,137**	**9,991**
EBITDA	**6,218**	**9,409**	**8,431**	**9,201**	**9,362**	**9,530**	**10,432**	**10,288**

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	8,643	9,679	9,729
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	401	222	43
Cash flow from operations	**5,700**	**5,845**	**7,844**	**9,507**	**11,264**	**11,137**	**10,636**	**10,711**
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**	**(1,461)**	**(2,533)**	**(2,698)**
Free cash flow	435	2,841	446	1,617	5,244	2,887	2,186	2,021

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	8,502	8,863	9,264
Total current assets	**10,184**	**11,938**	**13,192**	**13,759**	**14,941**	**15,529**	**15,601**	**16,249**
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	253,598	259,304	265,136
Total assets	**218,234**	**237,060**	**251,957**	**260,355**	**272,724**	**277,283**	**283,448**	**289,970**
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	31,315	35,306	37,888
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**	**56,283**	**58,885**	**61,974**
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	208,762	212,274	215,652
Shareholders' equity	**176,043**	**192,614**	**202,350**	**207,691**	**216,247**	**219,211**	**222,723**	**226,101**
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**	**277,283**	**283,448**	**289,970**
EV	152,068	151,439	153,409	153,660	152,007	152,587	154,407	156,458
Net debt/(cash)	**27,700**	**28,921**	**32,034**	**34,071**	**32,756**	**34,217**	**36,750**	**39,448**
BVPS (HKD)	**30.093**	**32.925**	**34.590**	**35.503**	**36.965**	**37.472**	**38.072**	**38.650**

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	(1.7)	18.0	(22.8)
EBITDA (YoY)	9.1	51.3	(10.4)	9.1	1.7	1.8	9.5	(1.4)
Operating profit (YoY)	9.5	53.2	(10.9)	9.2	1.7	1.7	9.6	(1.4)
Net profit (YoY)	14.1	58.6	(8.3)	12.5	(1.0)	4.7	12.1	0.5
Core EPS (fully-diluted) (YoY)	n.a.	58.6	(8.3)	12.5	(1.0)	4.7	12.1	0.5
Gross-profit margin	75.6	73.2	72.7	66.4	64.9	67.2	61.7	79.1
EBITDA margin	64.9	67.0	65.2	59.8	56.9	58.9	54.7	69.8
Operating-profit margin	62.6	65.4	63.3	58.1	55.3	57.2	53.1	67.8
Net profit margin	45.6	49.3	49.2	46.5	43.0	45.8	43.5	56.7
ROAE	2.6	3.8	3.2	3.5	3.3	3.4	3.8	3.7
ROAA	2.1	3.0	2.6	2.8	2.7	2.7	3.0	2.9
ROCE	3.0	4.3	3.5	3.7	3.6	3.6	3.9	3.7
ROIC	2.6	3.7	3.2	3.3	3.1	3.1	3.4	3.3
Net debt to equity	15.7	15.0	15.8	16.4	15.1	15.6	16.5	17.4
Effective tax rate	14.2	14.5	10.6	10.8	14.5	14.0	13.9	13.9
Accounts receivable (days)	59.3	63.3	76.9	63.4	62.9	69.0	65.7	93.4
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	7.8	9.1	8.9
Net dividend payout	80.3	50.6	55.2	54.0	58.7	60.0	57.7	59.6
Free cash flow yield	0.3	2.1	0.3	1.2	3.8	2.1	1.6	1.5

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 Pacific Place) and Island East (Taikoo Place). Swire Properties was listed on the Hong Kong stock market in January 2012.

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Rating	Percentage of total
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Source: Daiwa

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