Daiwa
Capital Markets

Special Report

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The Hong Kong Property Toolkit

A step-by-step guide to the past, present and future of the Hong Kong Property Sector

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The anomaly of the Hong Kong Property Sector

The Hong Kong Property Sector seems to be an anomaly when compared with other major property markets around the world, and we think the same can be said of Hong Kong property stocks relative to property stocks in other major markets.

While physical property in Hong Kong has performed strongly in recent years in terms of both price and rentals, Hong Kong property stocks are much cheaper than their global peers on most measures, including PBR and Price to NAV. Moreover, their discounts to book value and NAV are now larger than the historical averages. Yet the Hong Kong property companies have arguably never been stronger in terms of recurrent income and the returns they are seeing on their investments in China.

In our view, this disconnect between Hong Kong and other property markets has expanded in recent years. Since the Hong Kong property stocks have a combined market capitalisation of more than USD250bn (more than USD350bn if we also include the China property stocks), billions of dollars of investment value could be unlocked if the valuation discount applied to Hong Kong and China property stocks were to narrow by just 10pp.

Our goal with this report is to fill in the blanks for investors seeking to capitalise on this anomaly. Inside, we examine the structure of the Hong Kong property sector, chart how the market has developed over the years, look at the unique macro-economic drivers for the city, and outline how we foresee the market taking the step up and ultimately being considered comparable to the real-estate sectors of New York and London.

Jonas Kan, Head of Hong Kong and China Property

Chapter 1

What is Hong Kong property all about?

Hong Kong Property – the transformation of a city

Hong Kong in 1841

Source: Daiwa

Hong Kong today

Source: Daiwa

Hong Kong's property market: inextricably linked with the city's evolution as a city

"A barren island with hardly a house upon it" – Former British Foreign Secretary Lord Palmerston describing Hong Kong in 1842.

Hong Kong has evolved dramatically, its population ballooning from less than 10,000 in the 1840s to 5.1m by 1980 and 7.1m in 2013. The process has been fuelled by a continuous inflow of people, mostly from across the border in Mainland China, and is marked by the city's transformation from humble fishing village (1800s) to manufacturing centre (1970s and 1980s), and then to financial centre and commercial gateway to China (1990s and 2000s).

Although Hong Kong faces many challenges, including social and political ones, we think opportunities abound for the city. In our view, one factor that is often overlooked is the property market's inseparable relationship with Hong Kong's evolution as a city.

The evolution of Hong Kong

Source: Daiwa

There is no doubt that Hong Kong has undergone significant transformation over the past few decades. In the broadest sense, we see the evolution of Hong Kong's property market as a reflection of one simple fact: the stock of physical properties has not kept pace with the city's development.

As a result, the Hong Kong property market seems to be an anomaly. Covering just over 1,000 sq km, the territory has some of the world's most expensive real estate in the residential, office and retail segments. We have seen major corrections in rental and capital values for these assets in past years, but they have always rebounded to reach levels not seen in previous upcycles.

The per sq ft price achieved by some physical properties in Hong Kong seems incredible to some observers, and the question of whether the market is a bubble is one that is asked frequently and answered in many different ways.

Hong Kong real estate is expensive for a reason

If we assume that participants in a free market are not fools, then there must be profound reasons to explain why this phenomenon of constantly rising asset prices has continued for so long. Alan Greenspan once said that, very often, one can only tell whether there was a bubble when one looks back.

The gross cap rates achieved by some physical properties in Hong Kong are as low as 3% (granted, Hong Kong has no capital gains tax, the liquidity of physical properties is greater than in many markets, and negotiating upward revisions in rents is more straightforward than in many other places), and there seems to be a marked reluctance among owners of prime properties in Hong Kong to sell.

Considerable growth expectations have been built into the minds of owners of prime real estate in Hong Kong, and this situation has persisted for a reason. It pays to hold onto prime property assets in Hong Kong, with many people who have sold genuinely prime property in the city finding it almost impossible to buy back the property at the same price, never mind a lower one.

Still, what has worked in the past won't necessarily work in the future. In our opinion, whether Hong Kong property prices can hold steady depends critically on what Hong Kong as a city becomes in the future.

If there is a continuous inflow of capital and talent into the city, there appears to be no reason why property prices cannot rise further over time, especially given that central banks do not appear to be exercising strong restraints on the increase in money supply.

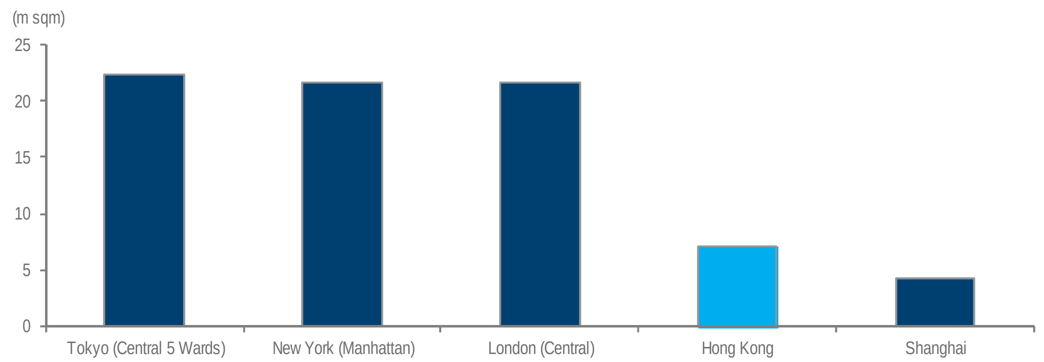
Ultimately, we think the cap on the unit price for most luxury residential real estate in a city is the net worth of the wealthiest prospective buyer. In the same vein, the ultimate cap on the rental value of the most sought-after office in a city is the profit per sq ft of the most profitable company in the city, and the ultimate cap on the rent for the most valuable retail shop in a city is the sales and operating profit per sq ft of that store.

The stock of prime physical properties in Hong Kong appears small if the city is to live up to our expectations that it will become one of the most important metropolitan cities in China. Hong Kong has fewer than 400 detached homes on the Peak and fewer than 2,500 on the whole of Hong Kong Island. We believe there are many more billionaires in the city.

Rentals for some office buildings in Hong Kong are among the world's highest, but perhaps just five buildings have achieved and sustained monthly rents of over USD15/sq ft. Moreover, there are no more than 30 major buildings in the Central Grade-A office market that meet the requirements of multinational companies (building with floor plates and other requisite specifications).

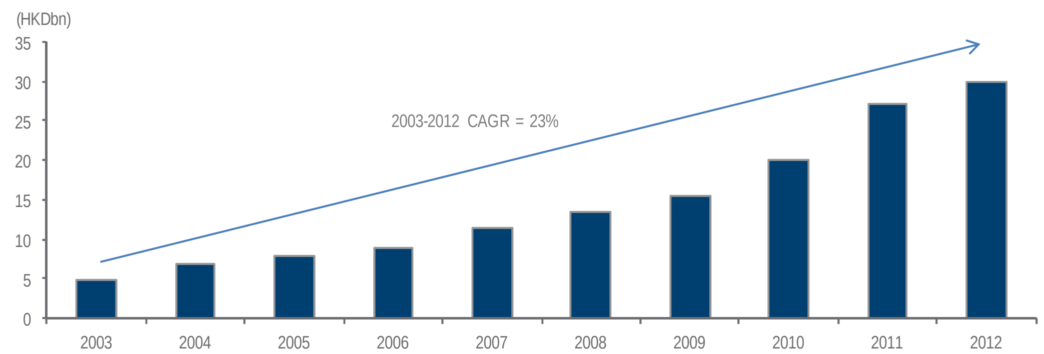
As it stands, Hong Kong's total Grade-A office stock is similar in size to that of San Francisco and less than half that of Manhattan. For retail properties, some shops in Hong Kong have achieved rents which are among the world's highest. But, for many international brands at least, their leading store in the whole world in terms of achieved sales per sq ft is on Hong Kong's Canton Road.

Grade-A office stock in Hong Kong versus international peers (2012)



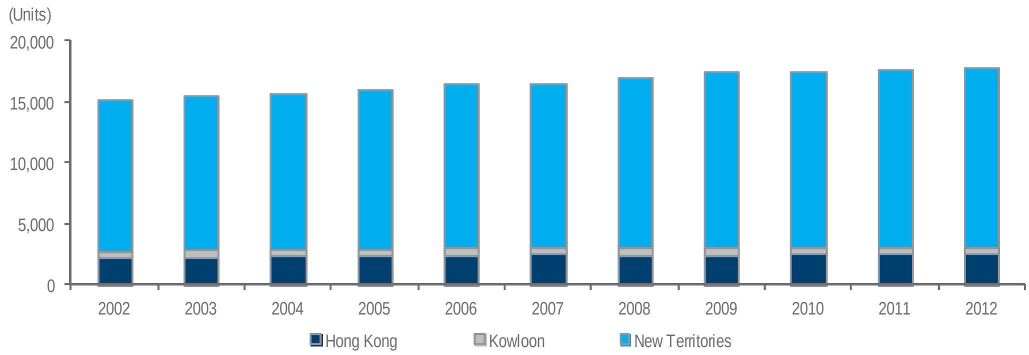
Source: DTZ

Achieved retail sales in Harbour City



Source: Wharf Holdings, Daiwa

Stock of detached houses in Hong Kong



Source: Rating and Valuation Department

Are these signs of bubbles? Could they also be viewed as market signals?
With property prices in Hong Kong high currently, we think it is legitimate to ask whether we are seeing signs that bubbles are forming, especially given that interest rates have been exceptionally low in recent years. We think there is a very real risk of asset-price bubbles being formed amid over-borrowing in Hong Kong. But, in our view, system-wide over-borrowing is not in evidence. While low interest rates have had a role to play, we do not believe that the rise in asset prices in recent years has been driven by people making undisciplined use of easy credit.

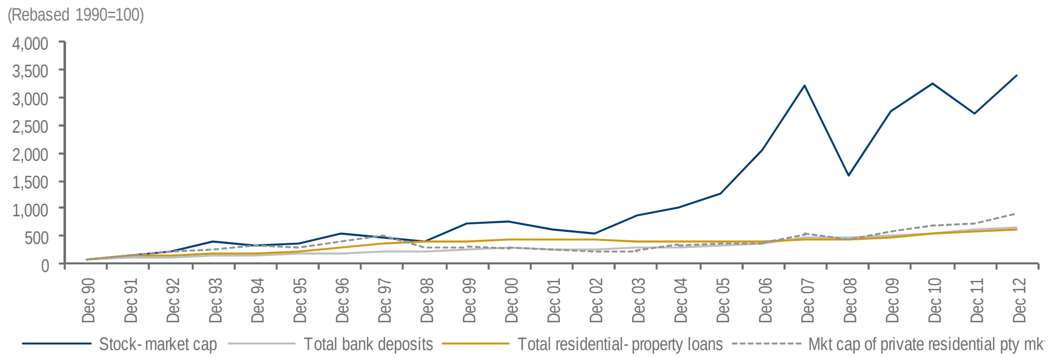
Indeed, one feature of the current property cycle is that participants seem restrained and prudent in their use of leverage. Prior to the beginning of the property upcycle in 2H03, Hong Kong had been through a six-year property-market downturn in which residential office prices and office rentals fell by as much as 70% (peak to bottom). We think this sustained period of price deflation has left many market participants reluctant to leverage up. It will likely take time for the psychological scars to heal.

At the same time, Asia's central banks appear to have learned from previous episodes of financial turmoil. They now seem determined to pre-empt the formation of asset-price bubbles by imposing administrative measures to make it hard for people to leverage up at an early stage of the cycle.

All things considered, we do not view prevailing property prices in Hong Kong as indicating either significant over-leverage or euphoric expectations in the market (also see Chapter 7).

What then do current property prices mean?

Hong Kong: growth in the private residential property market, bank deposits and stock-market capitalisation



Source: CEIC, Midland, Daiwa

The real-estate markets of financial centres have special characteristics

In our opinion, another way to view current property prices is as a sign of the market crying out that the stock of prime property in Hong Kong is insufficient to meet existing demand, much less to accomodate future demand.

Hong Kong as a city has continuously moved up the value chain over the past few decades, but the supply of land has been restrained, due partly to the nature of the land-supply process (see Chapter 3). Over the past few decades, the supply of land – especially prime land – has not increased fast enough to meet demand, and hence prices for most prime property assets continue to reach new highs.

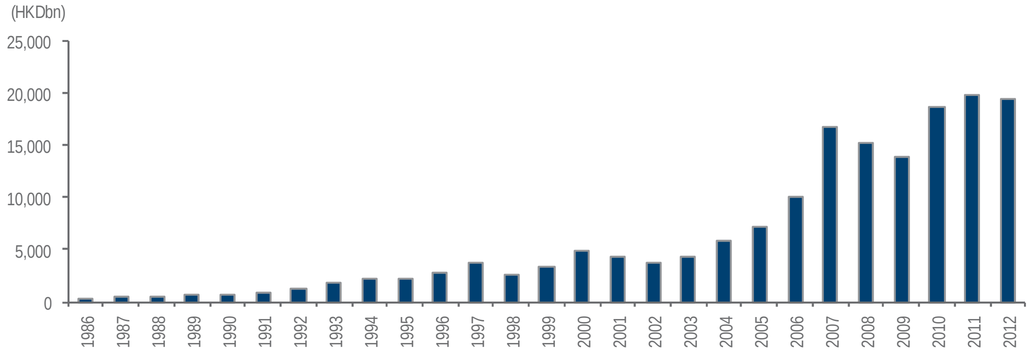
Super-imposed on this, in our view, is Hong Kong's continued evolution into an international finance centre. In our opinion, the real-estate market of an international financial centre has characteristics of its own, ie, it may not operate in the same way as other real-estate markets. In this context, the performance of properties in London has surprised many observers, with the upcycle in prices having lasted for more than two decades and each correction in prices being short-lived.

The world has only two genuinely international financial centres – London and New York – and both have developed in considerably different ways than other property markets in the same countries. We think there is a case to be made for taking into account the experiences of London and New York when analysing the property market in Hong Kong.

In terms of scale, Hong Kong as a financial centre is far behind London and New York. But it has grown rapidly in recent years, as measured by its stock-market capitalisation, and we believe that if there is to be an international financial centre in the Asian time zone, Hong Kong has the right credentials, if only because of the sheer size of the China economy.

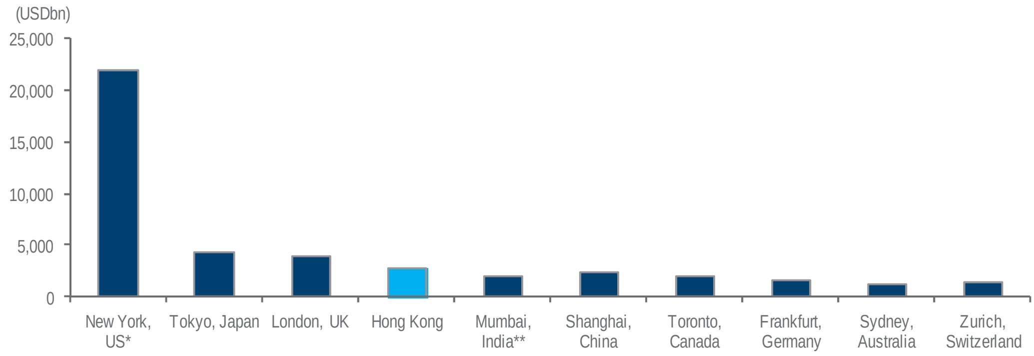
The fact that the physical property market in Hong Kong has not developed at the same pace as the financial sector could be a big factor behind the anomalous state of Hong Kong's real-estate market.

Growth in the stock-market capitalisation of Hong Kong



Source: Bloomberg, Daiwa

Stock-market capitalisation of Hong Kong vs. other major markets



Source: Wikipedia World Federation of Exchanges
*Note: *NYSE & NASDAQ, ** BSE & NSE; data as of end-August 2013*

Is Hong Kong property a play on Hong Kong as a city and on the scale of the China economy?
In our opinion, it is also important to analyse the Hong Kong Property Sector from the perspective of the development of Hong Kong as a city, and thus to consider it as a sector where the supply of land has not kept pace with the city's development, and one in which this bottleneck has persisted for many decades.

In general, property prices in a big metropolitan city in a large economy (Tokyo, Paris and London are obvious examples) tend to be markedly higher than those in the surrounding areas, and we believe this is mainly because people with high wealth and earnings power (and those aspiring to both) are inclined to cluster in a country's main cities, and that as a consequence these cities tend to attract a disproportionate share of the country's wealth and talent.

Moreover, buyers of prime property assets in these cities often are not confined to the local population; there is usually demand from a large base of foreign buyers – many of the properties in the prestigious Mayfair area and other prime districts in London are owned by non-UK residents.

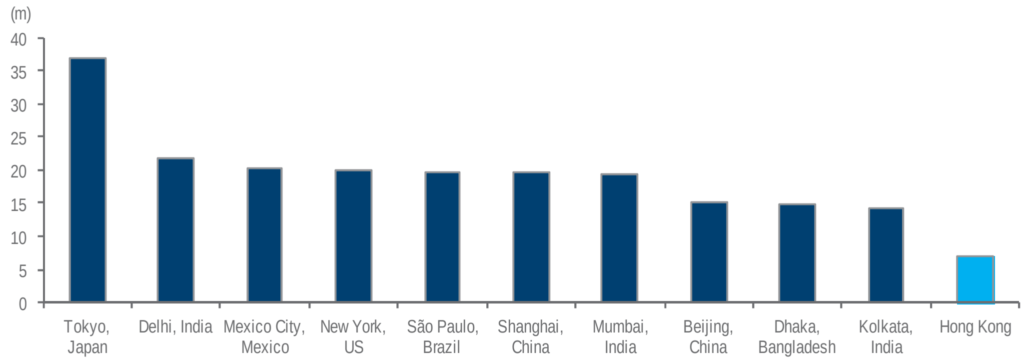
In addition, we have found that property prices in international financial centres tend to be much more resilient than in many other cities. Property prices for London and New York have stayed high for about two decades, despite the impact on their countries' economies of events such as the global financial crisis and Europe's sovereign debt crisis.

Thus, we believe the Hong Kong Property Sector offers a way to gain investment exposure to Hong Kong's prospects as a metropolitan city and an international financial centre. Also, the sector is arguably a way to invest in the scale of the China economy if the city of Hong Kong can transform itself into a magnet able to attract capital, talent, consumers and corporations from the entire country.

In the past, property assets in Hong Kong have mainly been within the reach of several million people, a few thousand major corporations, and probably 1-1.5m consumers in Hong Kong with discretionary consumer-spending power. In the future, however, Hong Kong property assets could attract a much larger Mainland population, consumer pool and business sector. Furthermore, we think Hong Kong could evolve beyond being a capital-raising centre for Mainland corporations and have a role to play in China's currency, fixed-income and commodity-trading sectors.

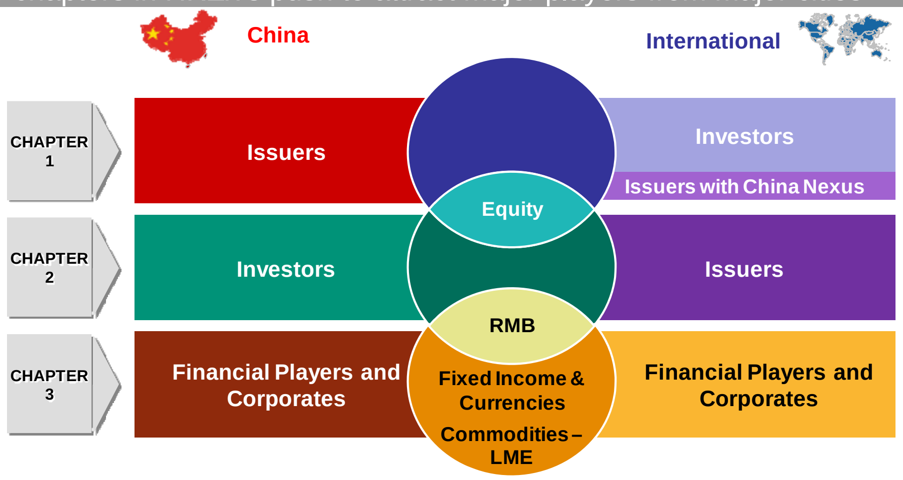
Thus, we believe Hong Kong has strong potential to become an all-round international financial centre for China; indeed, we believe the strategy pursued by Hong Kong Exchanges and Clearing (HKEx), the holding company for the Stock Exchange of Hong Kong, in recent years has been all about positioning for this opportunity.

Populations of major cities



Source: Wikipedia
Note: data as of end-2012

Three chapters in HKEx's push to attract major players from major cities



Source: HKEx

Are Hong Kong property stocks an attractive way of owning Hong Kong property assets?
We believe many participants in Hong Kong's physical property market recognise the appeal of Hong Kong properties we've discussed above, and that this is one reason why achieved cap rates for physical properties in Hong Kong tend to be low and achieved prices and rents for properties remain among the world's highest.

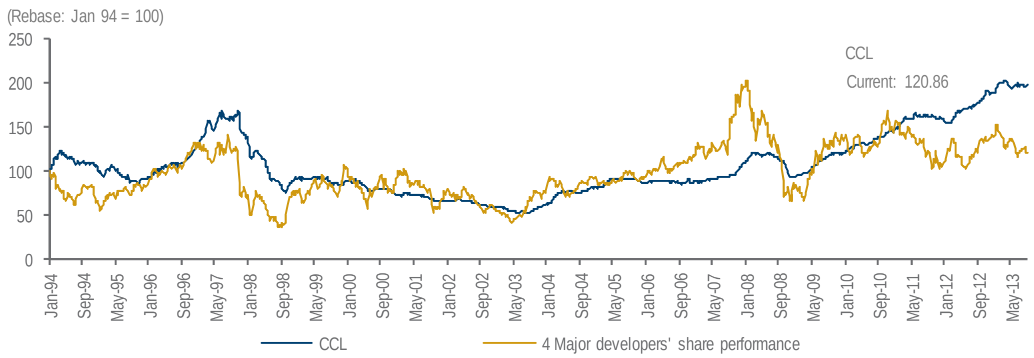
Given this, it seems puzzling that if physical property assets in Hong Kong are so valuable and sought-after, why are property stocks in Hong Kong still looking so cheap? In many major cities, it is almost impossible to buy most prime physical real-estate assets as they tend to be owned by a handful of people or entities who are unwilling to sell them or turn them into listed securities on the stock market.

In Hong Kong, however, nearly all of the most prime real estate is held through the publicly-listed companies, and at present the implied valuations of these assets seem to be just a fraction of the prices they are commanding in the physical property market. Why is this the case, and does it represent a genuine value opportunity for long-term investors? Are there really billions of dollars of investment value in Hong Kong property stocks waiting to be unlocked?

As Oscar Wilde put it: *"the truth is rarely pure, and never simple",* and we believe there is probably no straightforward answer to this question. The high discounts to NAV that Hong Kong property stocks are trading at currently are not new. These stocks have traded at large discounts to NAV for many years, though the discounts in the past (17-38% on average during past down-cycles) were not as pronounced as they are now (48% on average based on our end-2013E NAV).

We have identified reasons for these discounts (see Chapter 8). That said, we see no strong reasons why the discounts should not narrow over time. We believe systematic attempts to assess these reasons have been lacking so far, and thus we seek to address them within this report.

Disconnect between Hong Kong's physical property market and property developers' share prices



Source: Centaline Research, Daiwa
Note: The Centa-City Leading Index (CCL) is an index tracking residential-property prices

Chapter 2

Key features of the Hong Kong property market

One of the most consolidated property markets in the world

Hong Kong's property industry is highly concentrated compared with most other property industries globally, with a handful of players dominating in terms of market shares of sales and portfolio size within the residential, office and retail segments.

Our industry research shows that this has not come about due to regulatory barriers. Indeed, we believe the regulatory entry barriers into the Hong Kong property market may be among the lowest worldwide. Any company from any country or any industry could enter Hong Kong's property market, and if it had the capital to buy out all the land at government auctions or tenders, and some of the major commercial property assets, it could become one of the largest Hong Kong property players within a few years.

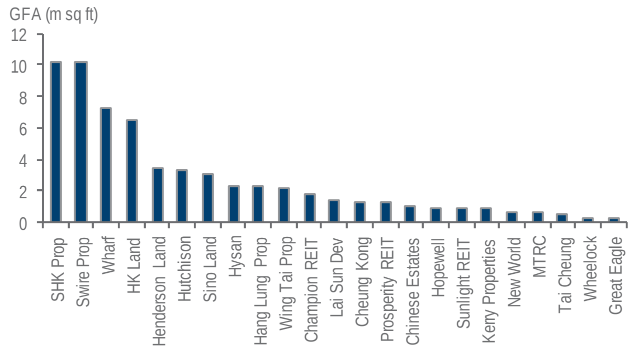
That said, the long-term trend of the Hong Kong property market has been one of growing concentration among a few major players, and not of a more equal market-share distribution among more players.

Distribution of primary property market sales in Hong Kong (2012)

Developer	No. of units	Total value (HKDm)
Cheung Kong	3,335	25,593
SHK Properties	1,606	16,729
Sino Land	1,900	21,231
Henderson Land	1,390	11,636
New World Development	892	11,406
Kerry	412	7,402
Wheelock	160	2,951
Hang Lung Properties	116	1,144
Swire Properties	14	1,481
Nan Fung	6	358

Source: Centaline, Daiwa

Office portfolio size of major Hong Kong-listed property companies (end-2012)



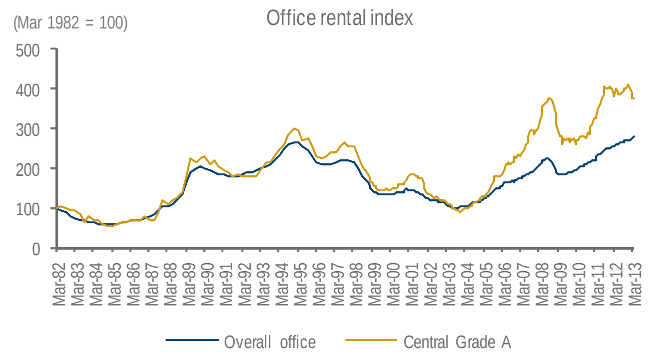
Source: Companies, Daiwa estimates

One of the most volatile property markets in the world

Property prices in Hong Kong have been very volatile over past years, which is unusual compared with many other property markets globally. During the industry upcycle from 1983 to 1997, residential property prices in Hong Kong rose more than ten-fold. However, during the downcycle between 3Q97 and 2Q03, residential property prices fell by up to 70% (and by 50% during the first 12 months of that six-year downturn).

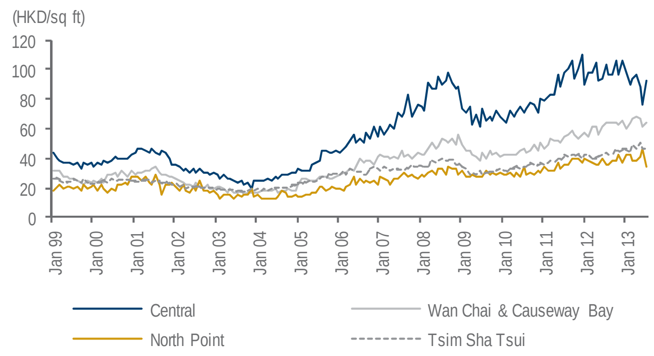
In most property markets worldwide, rents tend to be much more stable than capital values. In Hong Kong, however, Grade-A office rents in Central declined by as much as 70% over 3Q97-2Q03, then subsequently rebounded more than five-fold during three years from their trough level reached in mid-2003.

Grade-A office rents in Central and HK overall



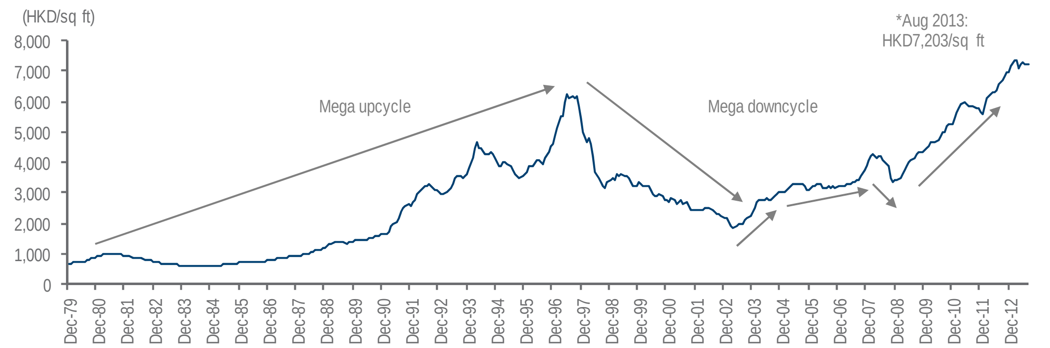
Source: CEIC

Rents in major Grade-A office locations



Source: CEIC, Daiwa

Residential property prices in Hong Kong



Source: Midland, Daiwa
Note: * Provisional figure

An unusual land market

The way in which land is sourced is often a key factor shaping the structure of a property sector. As such, we believe one of the most important developments in the history of the Hong Kong property market was the decision taken by the Hong Kong Government in the 19th century to create land (through reclamations and other means) and then sell it at open auctions and tenders to the highest bidder. That decision has resulted in capital strength becoming an important competitive factor for players in the Hong Kong property market.

Having capital is the key in Hong Kong

Our industry research shows that in many property markets globally, property companies need to devote considerable time and resources to acquire sites, and that in many cases it is almost impossible to get a large-scale site in the main city areas. It is not common for governments to create land and amalgamate sites. In fact, in many developed markets (like Madrid, Paris and London), government town planning and zoning rules often make it extremely difficult (or even impossible) for property companies to amalgamate sites and redevelop old buildings. This limits the size of property projects that developers can take on in the main city areas.

By contrast, in Hong Kong, as the bidding price is often the main criterion to decide who obtains the sites at government land sale auctions, property companies can concentrate more on strengthening their capital bases to fund their development activities. That said, unlike, say, the Government of Singapore, the Hong Kong Government has not maintained a land reserve and has not overtly used the land supply to influence the property market's development. This could be because it is not simple even for the government to obtain land in the New Territories, and because technically, the entire New Territories were supposed to be returned to China after 1997.

Furthermore, as the Hong Kong economy has expanded substantially over the past few decades, the amount of land offered by the Hong Kong Government has often not been enough to keep pace with the growth in demand. Hong Kong is one of the smallest of the world's major property markets in terms of per-capita living area in the private residential property segment and average office space per employee in the office segment (see Chapter 3).

There have been some ways to gain special access to land in Hong Kong

Another milestone in the development of the Hong Kong property market has been the Hong Kong Government's decision, taken several decades ago, to allow lease modifications, which enable developers to change the usage of a site (say from farmland/ shipyard land to residential or commercial use) by paying a land premium. This enables some developers to obtain large sites, some of which are in the urban area.

In addition, we believe the government's issuance of Land Exchange Entitlements (or the so-called 'Letter B') when it reclaimed land in the New Territories since the 1970s has been a key factor shaping the development and relative competitiveness of the different property developers, as this has allowed some developers to lock in the land cost for a large bundle of land at historical levels.

'Letter B' played a major role in the significant growth in earnings and asset bases of several major property companies in Hong Kong during the late1990s, in our view (the four major owners of 'Letter Bs' in Hong Kong are SHK Properties, Henderson Land, Chinachem [unlisted] and Nan Fung [unlisted]).

Main buyers of land in Hong Kong

	2011	2012	2013 (YTD)
SHK Properties	17.5%	18.1%	10.5%
Cheung Kong	38.6%	21.6%	0.0%
Henderson Land	0.0%	0.0%	0.9%
Sino Land	3.9%	3.5%	2.9%
Wheelock	13.2%	6.6%	22.3%
Kerry Properties	3.8%	4.7%	23.0%
Chinachem	0.0%	0.0%	9.6%
Nan Fung	1.3%	10.3%	0.0%
Swire Properties	0.6%	0.0%	1.1%
China Overseas Land & Investments	1.0%	5.0%	8.9%
New World Development	0.0%	5.0%	6.3%
K. Wah	0.0%	5.5%	0.0%
Lai Sun Development	0.0%	2.4%	0.0%
Hong Kong Ferry	0.7%	0.0%	0.0%
Emperor	1.1%	0.3%	0.0%
CSI Properties	0.0%	0.9%	0.0%
HKR	0.1%	0.0%	1.2%
Shangri-La	4.1%	0.0%	0.0%
Tai Cheung	0.0%	2.9%	0.0%
Wing Tai	1.3%	5.2%	4.0%
Hang Lung Properties	0.0%	0.0%	0.9%
China Vanke	0.0%	0.0%	1.5%
Paliburg	0.6%	0.0%	1.6%
Chun Wo	0.0%	0.0%	5.3%
Unlisted	12.0%	8.0%	0.0%
	100.0%	100.0%	100.0%

Source: Lands Department, Hong Kong Economic Times, Daiwa
Note: YTD figures up to August 2013

One of the most capital-intensive real-estate markets in the world

The Hong Kong property market is also characterised by its high level of capital intensity. Except for a handful of special sites, all the land in Hong Kong comprises leaseholds owned by the Hong Kong Government, which has adopted the land auction system (described in the preceding section) to sell most of the land through open auctions, whereby the land is sold to the highest bidders. In most cases, the land price has to be paid up front or within a few months after the auction. However, the banks in Hong Kong are generally cautious when it comes to financing land purchases, and developers can usually obtain at most 50% bank financing for the land they acquire.

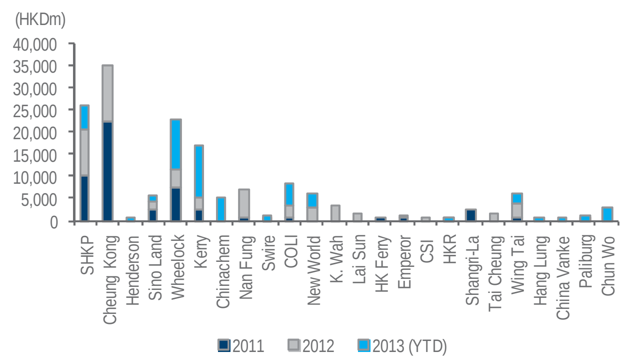
Furthermore, as property project completions in Hong Kong often take 4-6 years or more (and the trend is for this to continue to lengthen), the amount of capital required for property projects in Hong Kong ranks amongst the highest in the world.

Major sites sold in Hong Kong in recent years (top-10 sites in terms of achieved lump sum since 2011)

Site	Junction of Sheung Lok St & Sheung Shing St	21,23 and 25 Borrett Rd	Tsuen Wan West (TW5) Bayside	Java Rd and Tin Chiu St	Ex-Government Supplies Depot, Oil St	8-12 Deep Water Bay Drive, Shouson Hill	Shatin Area 56A Kau To (Site A)	Former Lingnan College, Stubbs Road	Junction of Hung Luen Rd & Kin Wan St	Junction of Fat Kwong St and Sheung Foo St
Date of auction / Tender award date	13-Mar-13	9-Jun-11	10-Aug-12	11-Jul-12	25-Aug-11	30-May-12	9-Aug-11	12-May-11	4-Aug-11	14-Jun-13
Method	Tender	Auction	Tender	Tender	Tender	Tender	Auction	Auction	Tender	Tender
District	Ho Man Tin	Mid-Levels West	Tsuen Wan	North Point	North Point	Southern District	Shatin	Mid-level	Hung Hom	Ho Man Tin
Usage	Residential	Residential	Residential & Commercial	Residential & Commercial	Hotel and Residential / Commercial	Residential	Residential	Residential	Commercial	Residential
Winner(s)	Kerry	Cheung Kong	Cheung Kong	SHK Properties	Cheung Kong	Nan Fung	Kerry/ Sino/ Manhattan	SHKP	Wheelock	Wheelock
Total GFA (sq ft)	1,142,168	435,296	2,235,144	739,272	755,633	248,135	1,031,471	180,835	589,996	387,764
Transaction price (HKDm)	11,688	11,650	9,631	6,910	6,267	6,000	5,500	4,490	4,028	3,829
Transaction price (HKD/sq ft)	10,233	26,763	4,309	9,347	8,294	24,180	5,332	24,829	6,827	9,875
Consensus range (HKDm)	9,000-14,850	10,200 - 15,500	7,380-8,950	7,387-8,470	6,470 - 9,068	4,460-7,440	7,220 - 9,270	2,710 - 4,550	3,371 - 5,015	3,490-4,381
Consensus range (HKD/sq ft)	7,880-13,000	23,412 - 35,608	3,300- 4,000	9,992-11,600	8,562 - 12,000	17,900-30,000	7,000 - 8,990	15,000 - 25,000	5,500 - 8,500	9,000-11,300

Source: Lands Department, HKET, Daiwa

Amount spent on direct land purchases



Source: Lands Department, Hong Kong Economic Times (HKET, Daiwa

Shareholders' funds of HK's property companies

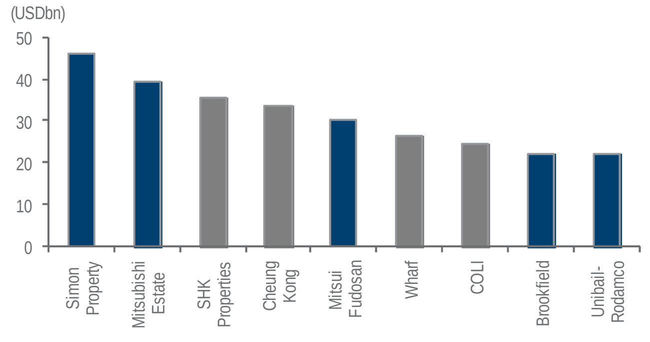
Developers	(HKDbn)	Investors	(HKDbn)	H-REITs	(HKDbn)
SHK Properties	385.9	Wharf Holdings	263.0	The Link REIT	81.6
Cheung Kong	335.4	Swire Properties	197.5	Hui Xian REIT	34.7
Henderson Land	212.8	Hang Lung Prop.	119.7	Champion REIT	45.3
Sino Land	104.8	Hongkong Land	204.7	Fortune REIT	17.1
New World	134.5	Hysan	60.6	Yuexiu REIT	15.8
Total	1,173.4		845.5		194.6

Source: Bloomberg, companies
Note: as at June 2013

One of the most polarised property markets in the world

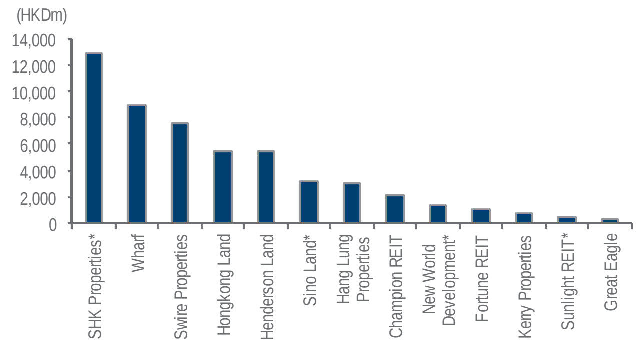
While Hong Kong Island is just a speck in the Pacific Ocean, Hong Kong has some of the world's largest real-estate companies in terms of market capitalisation, asset base and achieved profits. That said, the middle layer of the Hong Kong property industry is unusually thin; unlike most other markets, there are few medium-sized players in the Hong Kong property sector. The property companies in Hong Kong tend to be either large or small.

Major listed property companies in the world



Source: Bloomberg, Daiwa
Note: Data is for stock-market capitalisations as at 11 September 2013

Ranking of 2012 gross rental income from HK



Source: Companies, Daiwa
*Note: *Annualised*

Stock-market capitalisations of Hong Kong property companies

Developers		(HKDbn)	Investors		(HKDbn)	H-REITs		(HKDbn)
SHK Properties	16 HK, Buy, HKD102.6	275.4	Wharf Holdings	4 HK, Buy, HKD67.4	202.7	The Link REIT	823 HK, Buy, HKD34.7	79.8
Cheung Kong	1 HK, Buy, HKD113.6	265.7	Swire Properties	1972 HK, not rated	127.2	Hui Xian REIT	87001 HK, not rated	25.2
Henderson Land	12 HK, Buy, HKD47.3	125.6	Hang Lung Properties	101 HK, Buy, HKD26.2	114.2	Champion REIT	2778 HK, O/P, HKD3.6	20.3
Sino Land	83 HK, Buy, HKD10.9	65.4	Hongkong Land	HKL SP, not rated	116.2	Fortune REIT	778 HK, Buy, HKD6.1	11.1
New World Development	17 HK, not rated	73.1	Hysan Development	14 HK, Buy, HKD34.4	36.4	Yuexiu REIT	405 HK, Hold, HKD3.9	11.0
Total		805.1			596.7			147.5

Source: Bloomberg, Daiwa
Note: As of 11 September 2013; O/P = Outperform

Chapter 3

The topography of Hong Kong

Can a metropolitan city be built on land like Hong Kong Island?

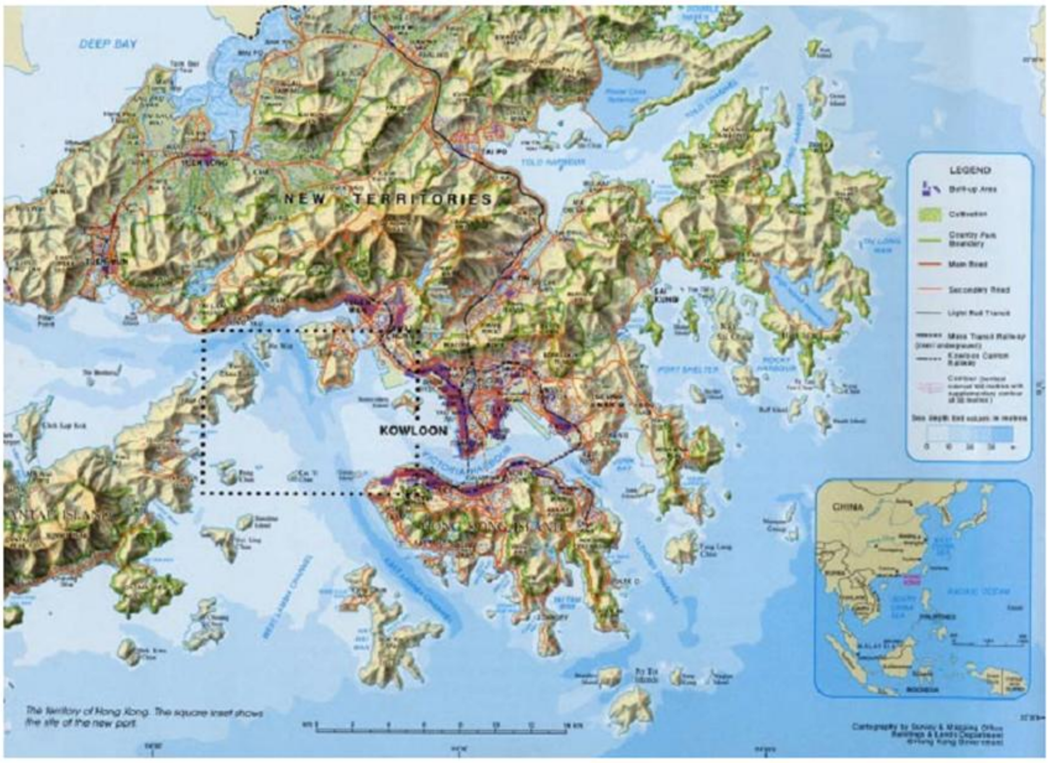
In our view, the topography of a city is often one of the most important factors shaping its property market, as the topography sets the parameters against which various economic and other factors operate.

For cities like London, New York, Tokyo and Paris, the flat land area is large and contiguous, which allows the city to continue to expand horizontally to accommodate growth in the scale of economic activities in those cities. By contrast, Hong Kong Island's topography is more similar to Gibraltar's, which is characterised by a large mountain at the centre of the island. Having a mountain in the middle of the island is not a problem if the city is primarily a trading port, as ports mainly require deep harbours; but it does pose a constraint on the scale of the development of a city.

In short, flat land is not readily available on Hong Kong Island. There is plenty of unused land at the centre of the island. It has to be created and this requires cost and forward planning. Not having abundant land has its pros and cons. The negative side is that land supply on Hong Kong Island tends to lag behind the territory's economic needs. Hong Kong often requires a sufficiently strong and evident economic case to be made before land can be created. On the plus side, though, there is less wastage of land in Hong Kong.

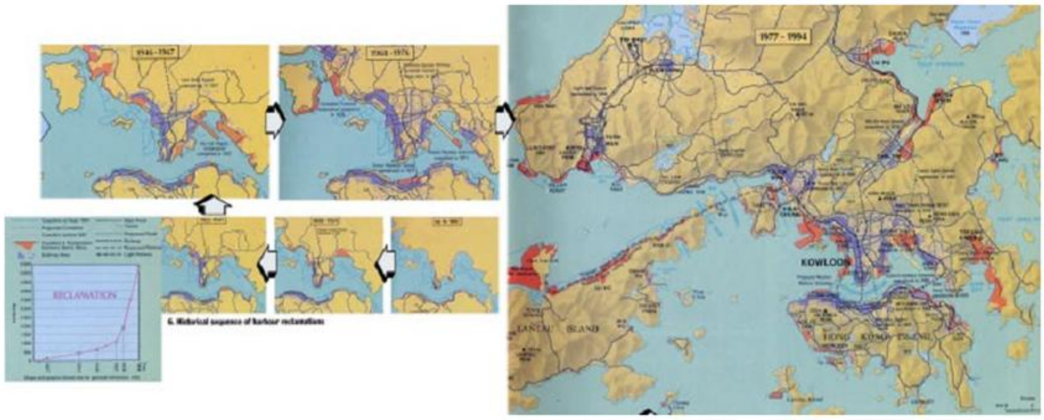
In any case, the land history of the Hong Kong is characterised by a series of land reclamations.

The topography of Hong Kong



Source: Government of the HKSAR

Reclamation in Hong Kong



Source: Government of the HKSAR

Land in Kowloon has helped, but is it enough?

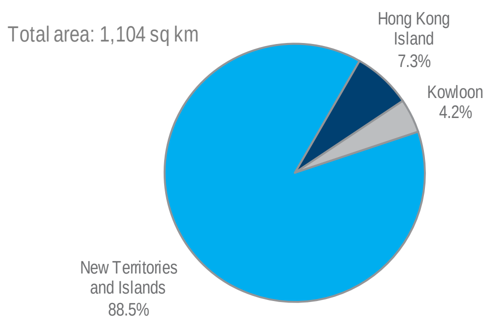
As history has shown, the flat land readily available on Hong Kong Island was just too small to support the development of a metropolitan city. And in retrospect, it was visionary businessmen like Paul Chater (the founder several major companies in Hong Kong, such as Hongkong Land, Wharf, Hong Kong Electric, China Light & Power, etc.), who in the late 1800s was instrumental in developing the Kowloon Peninsula. Many years later, this availability of land in Kowloon became critical to Hong Kong's transformation from a port into a manufacturing centre in the 1960s and 1970s.

That said, one issue faced by Hong Kong is that, in terms of land area, the largest proportion of land is in the New Territories. However, back in the 1860s, the then British Government did not own this part of the land. Pursuant to the Second Convention of Peking signed in 1898, the British Government would lease the area north of Boundary Street in Kowloon for 99 years, expiring in 1997, when it would be handed back to China. We believe the fact that this land was leased rather than owned by the British, and had been occupied by indigenous people for many years, prevented the government from being more active in making use of land in the New Territories.

Development of the New Territories has been a key factor in the sector's development

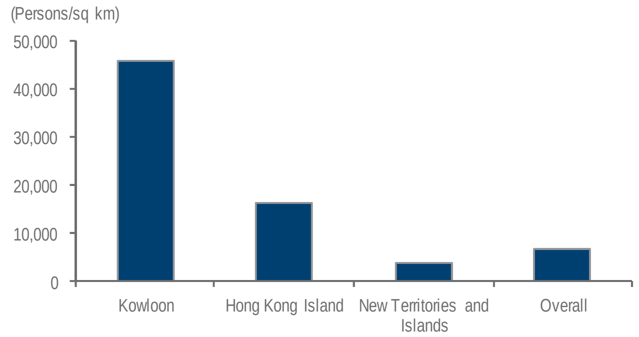
Nevertheless, economic and population pressure finally led to the Hong Kong Government embarking on developing new towns in the New Territories from the 1970s onwards. In our view, the development of the New Territories was a critical factor for the subsequent rise of the various Chinese property companies, as it provided a lot of land and projects for the property companies to acquire; and in fact many of the largest players in Hong Kong property now were active players in the development of the housing market in the New Territories.

Distribution of land area in Hong Kong



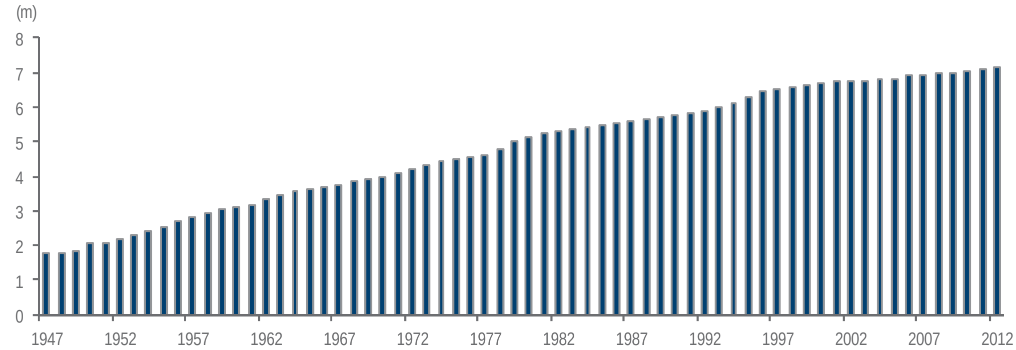
Source: Government of the HKSAR

Population density in Hong Kong



Source: Government of the HKSAR

Population growth in Hong Kong



Source: CEIC

What will be the main sources of land in the 2010s and beyond?

The construction of Hong Kong's international airport, Chek Lap Kok was the main infrastructure project in Hong Kong in the 1990s, and served as a major source of new land in Hong Kong. We believe the new residential projects built along the Airport Expressway were a factor in the downturn in the residential property market from 1997-2003. These units, which were the main source of new supply during the period, included premier units conveniently located next to the railway line. As a general rule, an oversupply of low-quality units tends to be a localised problem, ie, it does not affect units in other districts, while an oversupply of premier units tends to exert downward pressure on less well-located units.

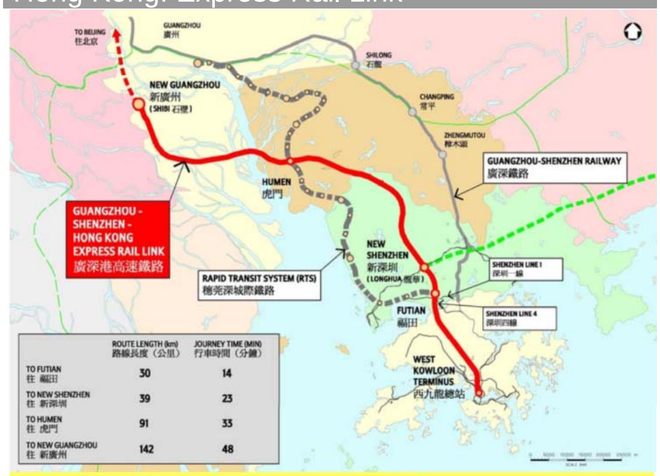
However, we think the residential property market downturn in Hong Kong during that time likely led the Hong Kong Government to swing to the other extreme in terms of land supply. While the land policy in the initial years of the CH Tung Administration (1997-2005) was characterised by 'no floor price on land', the economic and social consequences created by the property market downturn resulted in the government later shifting to the principle of 'not to sell land cheap'. Consequently, there has not been a new supply of land on a large scale in Hong Kong in recent years, whether for residential, office or retail properties.

Will the New Development Areas and farmland conversion be the key?

How will things change in the next few years? We believe that the government making more active use of the land in the New Territories is the most logical development. This is also consistent with its plans to develop the Northeast area of the New Territories. Given that the developers collectively own about 100m sq ft of land in the New Territories (we estimate that in recent years, the average annual completions of residential GFA in Hong Kong is about 10m sq ft), we believe that facilitating farmland conversion could result in tens of millions of residential GFA coming to market in the next few years, and this might constitute one main source of new land in Hong Kong in the second half of 2010s and the next decade.

However, if farmland conversion does not happen, we believe the pressure on property demand in Hong Kong could move across the border, especially given that infrastructure projects currently under way in Hong Kong will make it much more convenient for people in Southern China to come to Hong Kong and vice-versa.

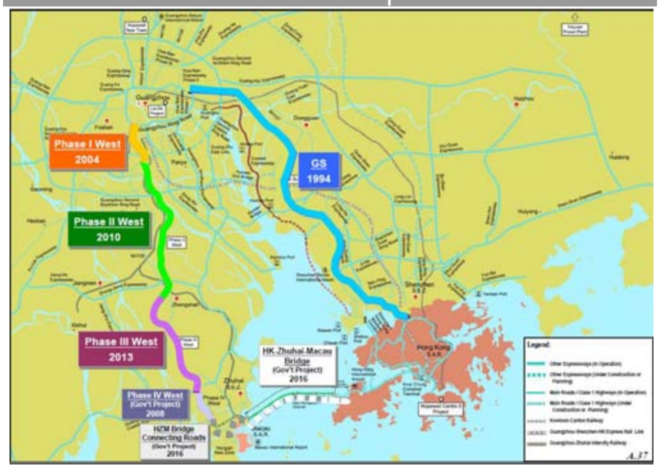
Hong Kong: Express Rail Link



Route Length (km)	26
No. of new station	1

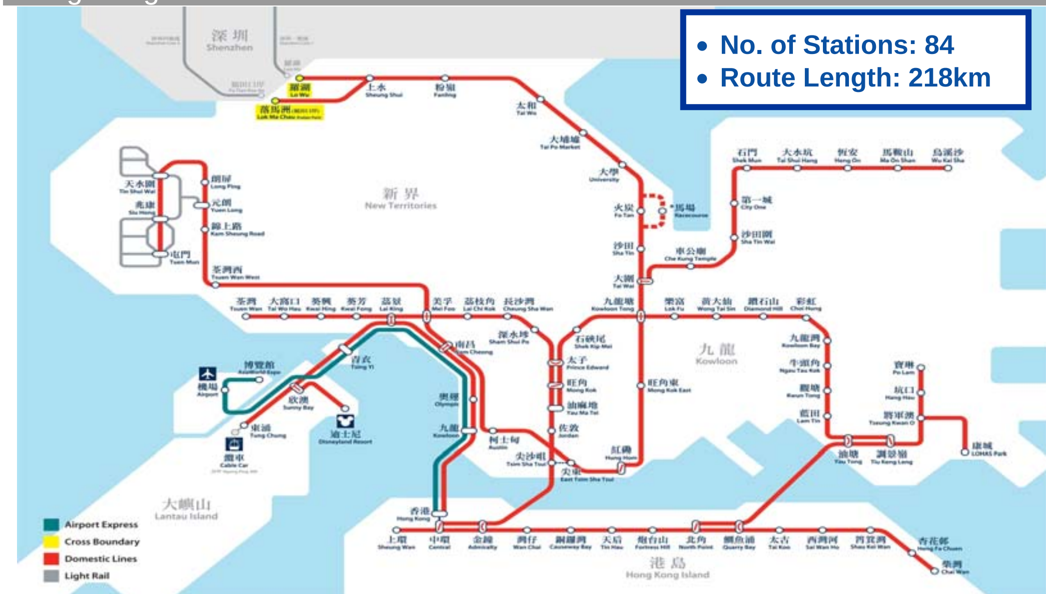
Source: MTRC

Pearl River Delta Area: transport infrastructure



Source: Hopewell

Hong Kong: new rail lines



Source: MTRC

Chapter 4

Residential property: 18 districts and the emergence of the three zones

Wealth distribution in Hong Kong

In our opinion, the distribution of residential property stock and prices in a property market, over time, tends to mirror the wealth structure of that city. In almost all cities, there tends to be five social groups: the super-wealthy, the wealthy, the high-income groups, the middle-income groups and the lower income groups. Our observation is that the range of wealth among Hong Kong's 7.1m population is huge, and may be among the widest in the world. Some of the world's wealthiest live in Hong Kong, but Hong Kong also has a sizeable portion of population whose annual income is less than USD13,000 a year.

The Hong Kong market seems to be still at an early stage of internationalisation

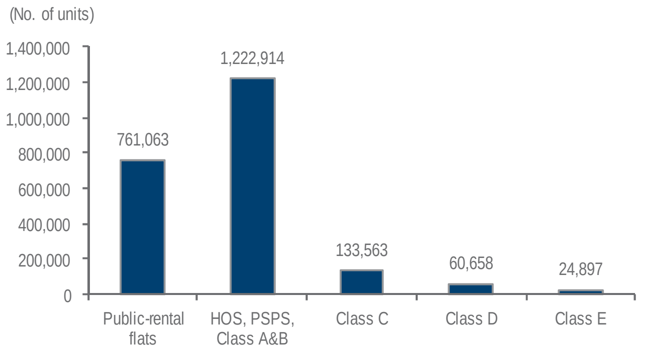
Another dimension of the Hong Kong residential property sector is the internationalisation of this sector. Such an internationalisation trend has been operating in the residential property markets of London and New York for many years, so much so that it is said that most of the residential properties in Mayfair and some other prestigious residential areas in London are owned by wealthy foreigners from the Middle East, Russia, etc.

In comparison, the internationalisation of the Hong Kong residential property market is in a much earlier stage and government policies in recent years (especially the Buyers' Stamp Duties – BSD – which requires foreign buyers to pay 15% of the transacted price as a stamp duty to the government) are certainly not conducive to foreign buying of residential property assets.

That said, our view is that the internationalisation of Hong Kong residential property is an inevitable trend if Hong Kong is to continue developing and evolving as an international financial sector. Also important to note, in our view, is the trend of greater social and economic integration between Hong Kong and Southern China, which is having a major impact on the Hong Kong residential property sector.

We envisage the Hong Kong residential property sector increasingly evolving into three different zones (Monte Carlo, Manhattan, and the rest of Hong Kong) and believe the profile and position of the 18 districts in Hong Kong are now in a state of flux – an issue we examine in the remaining parts of this report.

Structure of Hong Kong housing stock (2012)



Source: CEIC

Note: E - Private domestic units: more than 160 sq m

D - Private domestic units: 100-159.9 sq m

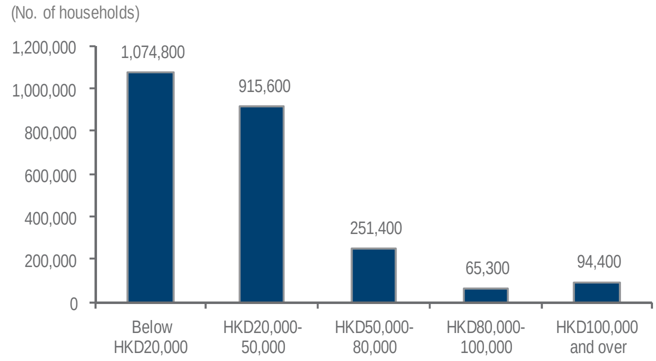
C - Private domestic units: 70-99.9 sq m

B - Private domestic units: 40-69.9 sq m

A - Private domestic units: less than 39.9 sq m

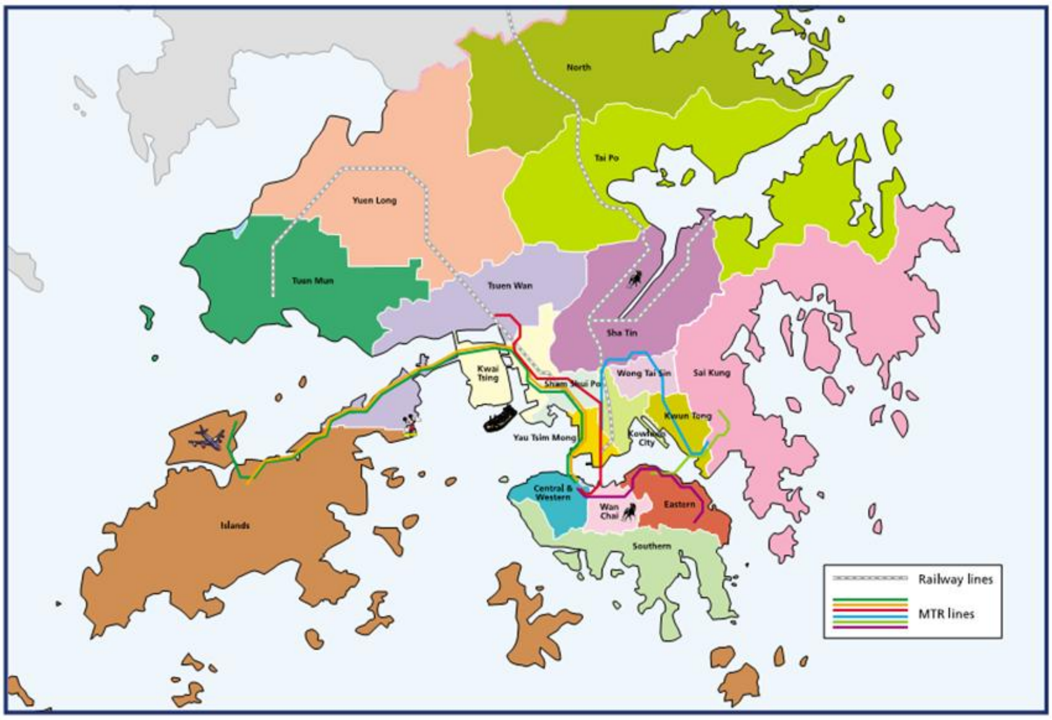
HOS, PSPS, etc - Home Ownership Scheme, Private-Sector Participation Scheme, Urban Improvement, Flat For Sale and Sandwich Class Housing Scheme

Structure of monthly household income in HK



Source: CEIC

The 18 districts in Hong Kong



Source: Daiwa

The 'Monte Carlo' areas – a niche segment

Hong Kong is very small in terms of area, yet some of the world's wealthiest live in the territory. Culturally, the Chinese have a tradition of owning properties. *The Economist* estimates that the number of Chinese people living overseas is more than 60m and Hong Kong is one of the places overseas Chinese tend to invest their money. And, of course, there is the mainland factor. According to a saying in China, "money has to be moved out of China to be truly yours".

While this might seem to be an over-statement, it is evident that in recent years, Mainland Chinese have been an important group of buyers of top-end luxury residential properties in Hong Kong, Singapore and increasingly in other cities like Toronto, Vancouver, New York, and London, etc.

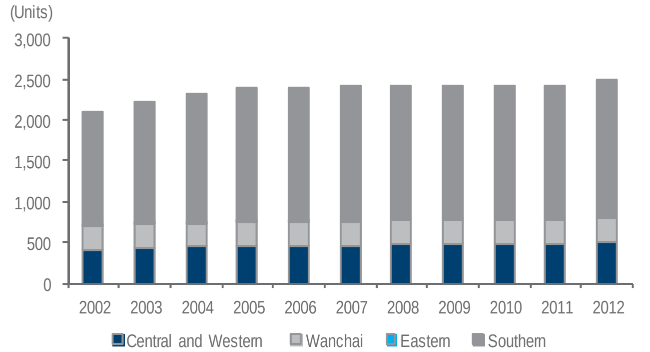
Just too few units in the super-luxury market

The stock of super-luxury residential property in Hong Kong is very small. In the whole of The Peak and Hong Kong Island, the number of detached houses is less than 500 and 2,500, respectively, according to the *Hong Kong Property Review 2013* – very small numbers relative to the billionaires (in HKD terms) in Hong Kong, which we estimate to be more than 10,000, and the wealthy people from Mainland China seeking to own residential units in Hong Kong, especially given that many of their children are coming to an age where they will also require property.

We define the Monte Carlo segment as one where the unit price is USD15m or more. In our opinion, the Monte Carlo part of the Hong Kong residential property market is confined mainly to The Peak and Island South, plus special units in a few areas such as West Kowloon (favoured by the wealthy from Mainland China), as well as Kowloon Tong and Homantin (traditional luxury residential areas in Kowloon). We see these areas as special segments of the Hong Kong residential property market, comprising a special niche market for mainly the top 1,000 in Hong Kong in terms of wealth, as well as the wealthy from China and overseas.

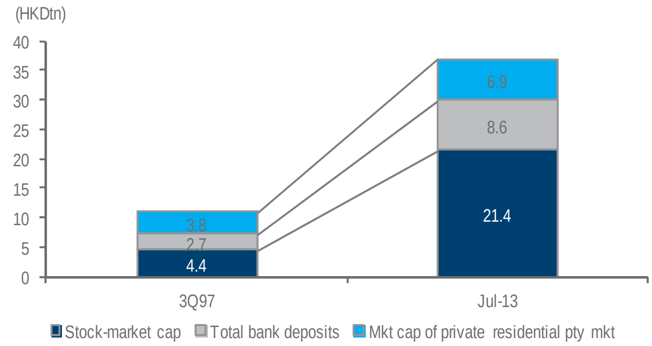
Given the very limited volume in this niche market, it is not the main source of profits for Hong Kong property companies. However, for those that own land in these areas, the achieved profit per unit can be substantial, especially for those that bought the land long time ago.

Number of houses on The Peak* and Hong Kong Island



Source: Rating and Valuation Department
Note: The Peak is in the Central and Western area

Size of the Hong Kong asset market and private wealth



Source: CEIC, Midland, Daiwa

Size of the Hong Kong asset market and private wealth (end-2012)

	(m sq ft)/ (m unit)	(HKDbn)	Unit price (HKDm)/ (HKD/sq ft)	Estimated debt (HKDbn)	NAV (HKDbn)	Owned by non-listed & local entities	Amount of private wealth (HKDbn)
HK private residential	1.1	5,000	4.5	877	4,123	95%	4,750
HK office	100	700	7,000	20%	560	50%	280
HK retail	100	1,500	15,000	20%	1,200	50%	600
HK Industrial	200	500	2,500	10%	450	90%	405
HOS units	0.32	800	2.5	30%	560	100%	560
Urban taxi	15,000	98	6.5	20%	78	100%	78
New Territories taxi	10,000	15	1.5	20%	12	100%	12
Minibus	10,000	80	8	20%	64	100%	64
Bank deposit		8,400		-	8,400	80%	6,720
		17,093			15,447		13,469
HK stock market		21,900				15%	3,285
		38,993					16,754

% of HK's private wealth shared by the top 100,000 people	80%
Amount of HK's private wealth shared by the top 100,000 people	13,403
Average private wealth of HK's top 100,000 people (HKDm)	134

Source: CEIC, Hong Kong Property Review 2013, Daiwa

‘Manhattan’ areas – where is the boundary?

We define the Manhattan price areas in Hong Kong as those where entry level units command a price tag of USD1m or more. Like New York’s Manhattan or Central London, the range of prices for units within this segment is large, encompassing those in the USD1-15m range, based on our definition. The areas that fall into the Manhattan price band have been growing in recent years and now new units in most areas on Hong Kong Island seem to already command Manhattan prices. Our view is that, as long as Hong Kong can sustain its status as an international financial centre, it will have Manhattan price areas, with the question being what is the boundary?

The areas that command Manhattan prices in Hong Kong have been spreading in recent years, and under our base case, for new units, all of the urban areas of Hong Kong will command Manhattan prices over time. At the end of 2012, the total number of units in Class D or above (100sq m in terms of internal floor area, per the Government’s definition) on Hong Kong Island and the Kowloon Peninsula was just 62,167 units, with at least 50% over 20 years old.

The “Manhattan price zone” may spread beyond the urban areas

Even if we relax the criteria to include Class C units (70-99.9 sq m in terms of internal floor area), the total number is still 140,992 units, which does not seem very large. According to figures from the Inland Revenue Department, as of March 2013, Hong Kong has some 111,600 households with monthly incomes of over HKD100,000, but note that some people in Hong Kong have become wealthy mainly by owning Hong Kong assets early and may not have incomes at all.

Another feature of the Manhattan price zone is the existence of foreign buying for long-term investment or periodic occupation. We believe that there are enough wealthy and high-income people in Hong Kong to support all the urban areas with new units at Manhattan prices. Indeed, our view is that, since many of the housing units in Hong Kong urban areas are old, there is a tendency for some of the wealthy and higher-income groups to consider areas in the New Territories, which is not far from the urban areas (shown as Zone 3 on the following map) and an area where we think some units will be able to attain Manhattan prices.

In our opinion, the existence and the spreading of the Manhattan price area in Hong Kong would bring considerable opportunities to owners of old buildings in urban areas, as there should be considerable room for the value associated with them to be unlocked. This, too, would provide room for a potential quantum in ASPs for projects that can be upgraded to enter the Manhattan price band.

Structure of residential stock in terms of unit size and price

Private housing stocks (No. of units) – end-2012

	Class A	Class B	Class C	Class D	Class E	Total
HK Island	105,632	136,570	38,552	26,650	15,848	323,252
Kowloon	127,361	165,397	40,273	16,932	2,737	352,700
New Territories	120,030	243,824	54,738	17,076	6,312	441,980
Total	353,023	545,791	133,563	60,658	24,897	1,117,932

Private housing price (HKD/sq ft) – July 2013

	Class A	Class B	Class C	Class D	Class E
HK Island	11,424	11,880	14,499	17,414	30,604
Kowloon	8,848	9,612	12,427	13,994	19,108
New Territories	7,813	7,016	8,214	7,413	9,358

Private housing price (HKDm/unit) – July 2013

	Class A	Class B	Class C	Class D	Class E
HK Island	4.1	7.8	14.7	27.1	65.9
Kowloon	3.2	6.3	12.6	21.8	41.1
New Territories	2.8	4.6	8.4	11.5	20.1

Source: CEIC, Daiwa

Residential property prices in Hong Kong

Source: Daiwa

Zone 1: Already has "Manhattan prices"

Zone 2: Likely to have "Manhattan prices"

Zone 3: Some projects may be able to have 'Manhattan prices"

Zone 4: "Rest of HK prices", though selected projects could command significant premium versus those in vicinity

The rest of Hong Kong – where the bulk of the local population lives

In London and New York, many people live in areas outside Central London and Manhattan, often commuting for more than an hour to their places of work. People with families in particular often prefer living further away as the city centre may not be the most desirable living environment for families with children, hence, an hour or more commuting time is a common and well-accepted practice in many of the world's metropolitan cities. In our view, this idea of commuting is probably something the Hong Kong population will have to accept eventually.

Still, we believe there are psychological barriers to commuting, given that Hong Kong is one of only a few major cities in the world (other examples being Geneva or Singapore) where people are used to commuting for 30 minutes or less. In our view, this resembles the psychology that corporations in Hong Kong once had about office addresses in Central. However, commercial pressure and market forces have finally removed this perception in the Hong Kong office sector in recent years, and our view is that, eventually, the same may happen to the local populace in terms of living areas.

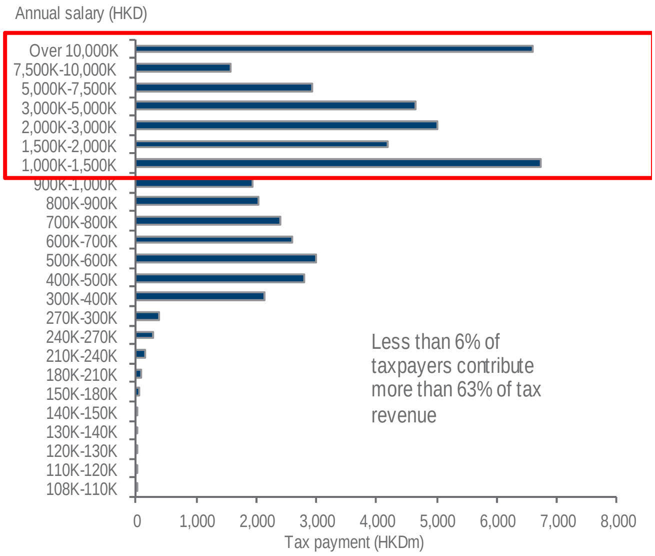
More normal segment, but don't underestimate the factor of home equity

The segment we call the 'rest of Hong Kong' is one that mostly comprises the local population and local middle class, and hence this segment would be the most cogniscent of income and affordability. Note that upgrading of dwellings is very common in Hong Kong, and the proceeds and gains people can realise from existing units is often an important component in the whole equation.

One important development is that there has been a surge in home equity in recent years, and according to the most recent government census survey, more than 60% of households in Hong Kong have paid off their mortgages, which augurs well for their ability to upgrade. We believe that this is an important factor when considering the unit price that Hong Kong buyers can afford.

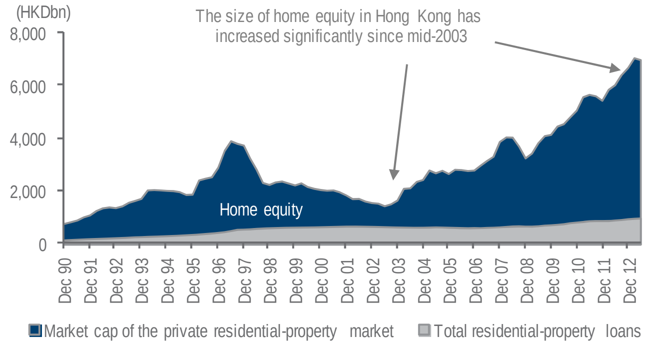
Another is that some people who previously lived in the Mainland have become part of the local populace. The way they look at different districts may not be the same as the in situ population. A case in point is the northwest New Territories. To the local population, this area is traditionally inhabited by lower-income groups. However, behind the northwest New Territories are Futian and Nan Sha, which are respectively the Central Business District (CBD) and a high-end residential area in Shenzhen. We are seeing some signs of changes in the demand profile and product positioning for units in these areas, and we expect this new dimension to residential areas in the New Territories to gradually play out in the coming years. In our view, this new way of viewing certain areas should create opportunities for developers to upgrade the positioning and image of their products.

Income structure in Hong Kong



Source: CEIC, Daiwa

Home equity in Hong Kong



Source: CEIC, Daiwa

Affordable unit-price range of different income groups

	Monthly household income					
	Below HKD20,000	HKD20,000-50,000	HKD50,000-80,000	HKD80,000-100,000	HKD100,000 and over	Total
	(No. of households)	(No. of households)	(No. of households)	(No. of households)	(No. of households)	(No. of households)
2005	1,282,000	695,000	135,000	36,000	49,500	2,197,500
2006	1,266,600	739,500	144,800	32,200	51,700	2,234,800
2007	1,217,500	758,100	168,800	36,900	65,900	2,247,200
2008	1,207,200	801,300	171,800	38,100	66,600	2,285,000
2009	1,259,400	774,000	170,900	39,800	64,100	2,308,200
2010	1,226,000	796,800	186,400	48,400	75,400	2,333,000
2011	1,143,100	846,500	225,700	49,400	94,700	2,359,400
2012	1,096,500	906,400	235,800	57,300	88,600	2,384,600
Unit price of affordable units*	HKD2.4m or below	HKD2.4m - 6.0m	HKD6.0m - 9.6m	HKD9.6m - 12.0m	Above HKD12.0m	

Source: CEIC, Daiwa estimates

Note: *based on 10x annual household income

Chapter 5

Office property: the five layers

Has the Central-led period come to an end?

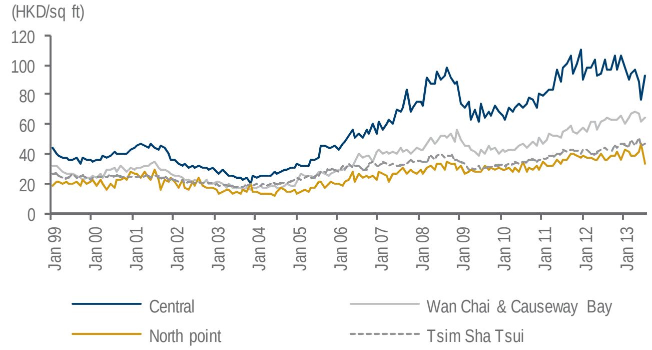
The Hong Kong office market began to take shape in the 1970s, when Hong Kong gradually moved from being a manufacturing centre to a business hub and financial centre. One characteristic of the Hong Kong office market was that it used to be Central-centric in that the rental and market situation in the Central market previously set the tone for the other sub-markets and the Hong Kong office market as a whole. Indeed, one could argue that the Hong Kong Grade-A office market was in the past a Central-led sector, in that it was rising rents in Central that led to demand spilling over to other districts, and Central rents were the trend-setter in terms of the rental direction for the whole sector.

Moving to Kowloon: the psychological barriers have been broken

Such was the situation until 2008. In our view, it was the success of International Commerce Centre (ICC) in securing three major investment banks as tenants that broke the psychological barrier related to changing office addresses to Kowloon, a tendency reinforced by the global financial turmoil which resulted in many multinationals prioritising cost savings. On the other hand, the completion of several high quality Grade-A office buildings in Kowloon East around that time also served as a strong pulling factor.

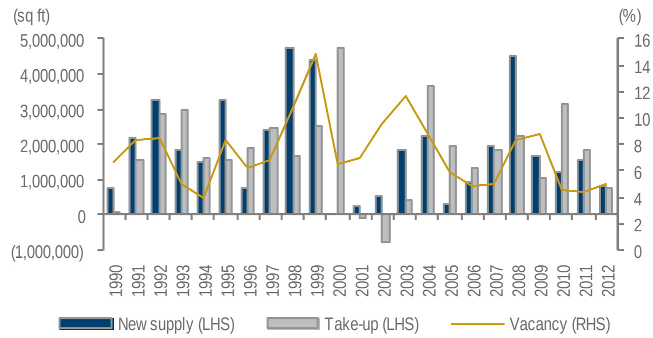
Our view is that the trend of decentralisation, of which there had been much talk in the past, has finally materialised and we believe it has now reached a point of no return. What this means, in our view, is that there will be a re-distribution of the vacant office space in Hong Kong, a trend that has been ongoing in recent years and which we expect to continue in the near future. Indeed, in terms of rental performance, the situation over the past two years has been characterised by a divergence in rental performance between Central and other sub-markets. While the Central Grade-A office market is still seeing downward rental pressure, especially in buildings with high vacancy rates, rents in other markets have been generally rising, with vacancy rates in office areas outsides Central staying at among the lowest level on record.

Rents in major Grade-A office locations



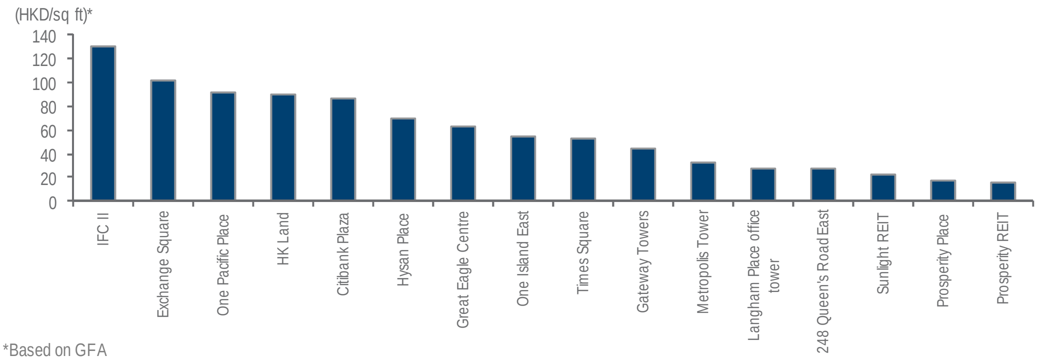
Source: CEIC, Daiwa

Grade-A office vacancy rates and take-up



Source: CBRE

Achieved rents for the main office properties in Hong Kong (2012)



*Based on GFA

Source: Companies, Daiwa estimates

Central is not weakening

Does this mean the decline of Central in terms of its position in the Hong Kong Grade-A office market? We do not think so. From a broader perspective, we see this as the market's way of addressing several long-standing issues in the Hong Kong office segment.

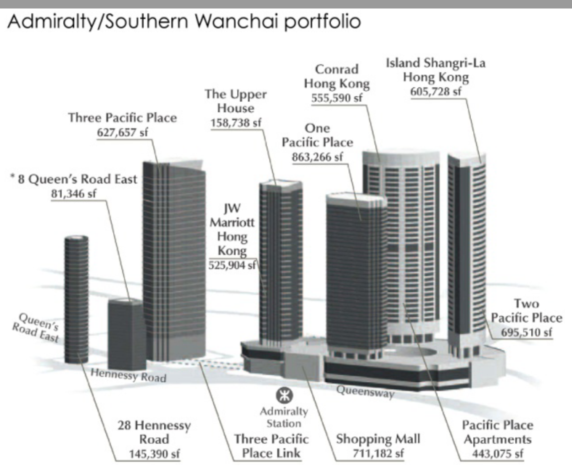
The significant increase in Central office rents versus other sub-markets since 2005 appears an anomaly. We think it resulted from the sudden and significant quantum leap in Hong Kong's scale as an international financial centre from the mid-2000s onwards – several mega IPOs from China and overseas resulted in Hong Kong becoming the No.1 market in the world in terms of funds raised from IPOs in several of the following years. At one point, rents in the premier Grade-A office buildings in Central were as much as 3x higher than those achieved in premier buildings in other sub-markets. However, Hong Kong is such a small place that from Central to even the furthest sub-market at Kowloon East is within 30 minutes by car, while travelling from one end of Manhattan or London to the other often will take more than 30 minutes.

In our opinion, the kind of dominance Central had over other markets from 2005-10 (which probably partly reflected the dominance of the investment banking industry over other industries in the economy) was abnormal and probably not healthy for the sector in the long run. We think Central needs to expand in terms of size and scale to accommodate the change in the profile and scale of demand on the Hong Kong office market, and believe it is arguable that this is what has been happening since 2009.

Central is changing and expanding in geographical reach

From our perspective, Central is not weakening – it is changing and expanding. We believe a Greater Central is forming. In the past, Pacific Place was often regarded as fringe Central, and Admiralty was regarded as another sub-market with rental levels at a discount to those in Central. However, the distinction between Admiralty and Central has become blurred, and we believe Pacific Place and Admiralty have now merged to become an integral part of Central, which looks to be on its way to include the eastern portion of Queen's Road East in Southern Wanchai.

Swire Properties' Pacific Place portfolio



Source: Companies, Daiwa

Development of Swire Properties' Pacific Place portfolio

Projects	Area	Year of completion	GFA (sq ft)	Cumulated GFA (sq ft)
One Pacific Place	Admiralty	1988	863,266	863,266
Two Pacific Place	Admiralty	1990	695,510	1,558,776
Three Pacific Place	Wanchai	2004	627,353	2,186,129
Three Pacific Place extension	Wanchai	2015	50,000	2,236,129
28 Hennessy Road	Wanchai	2013	145,390	2,381,519
8 Queen's Road East	Wanchai	2013	81,346	2,462,865

Source: Companies, Daiwa estimates

Central has expanded in size and scale

Source: Daiwa

Broader, healthier, more balanced and mature

We have argued earlier in this report that Hong Kong property is a sector where the supply of land has lagged behind the pace of development of its economy. We see the past situation of the Hong Kong Grade-A office market as a good illustration of this. We would argue that the development of the Hong Kong Grade-A office market exemplifies how market forces operate to adapt to the situation and to self-correct the excesses that resulted from the abnormal situation it was in.

A "soft landing" created by natural market forces?

Did the Hong Kong Grade-A office sector show the way? In our opinion, the emergence of HK East in the 1990s, and later Kowloon East in the 2000s, can be seen as the market's response to the situation of inadequate stock of quality office space in Hong Kong and the unusually high Grade-A office rents in Central. We believe that, in some ways, the emergence of HK East and Kowloon East as alternative Grade-A office locations opened up new choices for multinationals aiming to maintain and grow their presence in Hong Kong. Our interpretation of the development of the sector in recent years is that market participants so far, by and large, have responded positively and constructively to these new opportunities.

In our opinion, market forces have now been set in motion to address many long-standing issues in the Hong Kong office sector, but we would note that this was not really initiated by the government although its plans to supply more land in Kowloon East to build up the scale of the area as a commercial district have helped to reinforce this trend. The scale of Hong Kong's Grade-A office market looks small at present if Hong Kong is to live up to the expectations placed upon it to become one of the world's major international financial centres and business hubs, but we think it is in the process of making this change.

We envisage the Hong Kong Grade-A office market evolving into one that consists of five major layers, each with its respective profile and relative positioning (as shown in the tables below).

Daiwa's five layers of the Hong Kong office market – by size

	(m sq ft – ne t floor area)	Current size	Size by 2019E	Size by 2029E
1	Greater Central	23.3	24.2	28.6
2	The four established core office areas	23.5	24.8	27.2
3	Kowloon East	9.3	13.5	25.5
4	The five satellite office areas	7.8	8.9	9.4
5	Rest of the market	1.0	1.7	1.7
		65.0	73.1	92.4
	Central	13.6	14.4	15.8
	Admiralty & Pacific Place's Wanchai extension	4.7	4.8	4.8
	Sheung Wan	3.2	3.2	3.2
	West Kowloon	1.9	1.9	4.9
		23.3	24.2	28.6
	Wanchai	6.3	6.5	7.8
	Causeway Bay	3.4	3.5	3.5
	Tsimshatsui	6.0	6.3	6.3
	Island East	7.7	8.4	9.5
		23.5	24.8	27.2
	Kowloon East	9.3	13.5	25.5
	Kwai Chung & Tsuen Wan	1.5	1.9	2.2
	Tsimshatsui East	3.5	3.5	3.5
	Cheung Sha Wan	0.6	0.9	0.9
	Mongkok	1.2	1.2	1.2
	Hunghom	1.0	1.4	1.6
		7.8	8.9	9.4
	Other areas	1.0	1.7	1.7
	Total	65.0	73.1	92.4

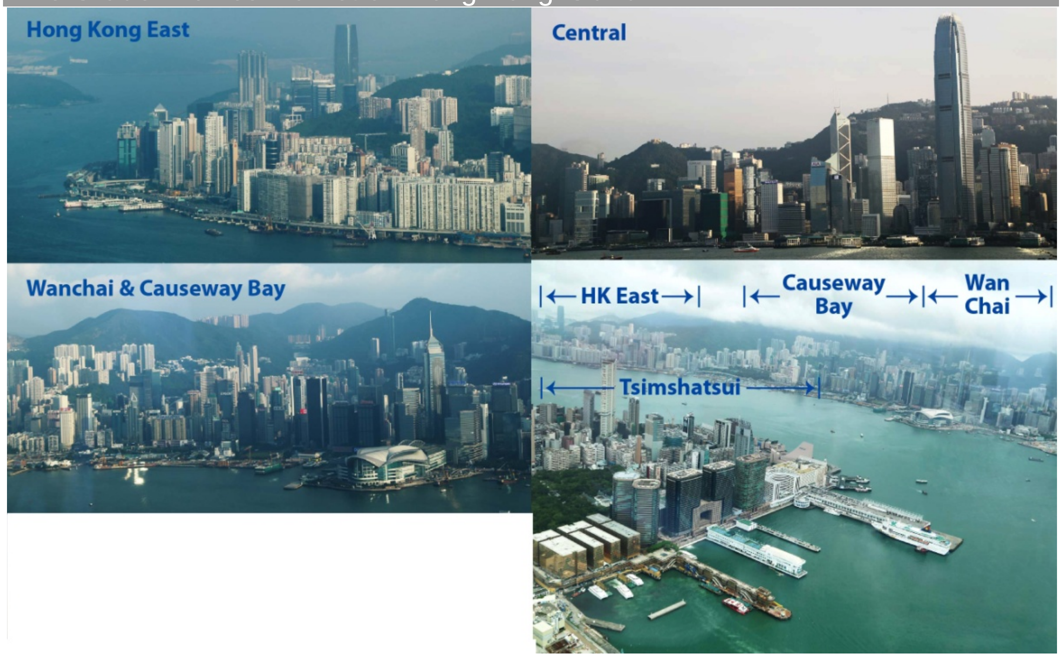
Source: Daiwa Note: Greater Central: Central, Admiralty, Pacific Place's Wanchai extension, West Kowloon, Sheung Wan
Four established core office areas: Wanchai, Causeway Bay, Tsimshatsui, Island East
Kowloon East: Kowloon Bay, Kwun Tong and Kai Tak redevelopment
Five satellite office areas: Mongkok, Hunghom, Tsimshatsui East, Kwai Chung & Tsuen Wan; Cheung Sha Wan
Rest of the market: Wong Chuk Hang, Tuen Mun, Shatin, Sheung Shui etc.

Daiwa's five layers of the Hong Kong office market – by relative positioning

Major office markets	Areas	Remarks
Greater Central:	Central, Admiralty, Pacific Place's Wanchai extension, West Kowloon, Sheung Wan	Central is the core, but will expand and integrate into neighbourhood areas which offer different and complementary office options
Four established core office areas:	Wanchai, Causeway Bay, Tsimshatsui, Island East	Offering alternatives to corporations which may not be finance-centric; Causeway Bay and Tsimshatsui could offer special appeal to retail and fashion related corporations
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
Five satellite office areas:	Mongkok, Hunghom, Tsimshatsui East, Kwai Chung & Tsuen Wan; Cheung Sha Wan	Offering additional and likely cheaper alternatives to corporations
		Could fit those companies moving out of the above locations
		Could satisfy some of the ownership demand for offices
Rest of the market:	Wong Chuk Hang, Tuen Mun, Shatin, Sheung Shui etc.	Do not have sufficient critical mass in their own rights but could satisfy some niche demand of specific industries

Source: Daiwa

The Grade-A office market on Hong Kong Island



Source: Daiwa

Will the four districts and Kowloon East end up as CBD2?

With regards to the five-layer structure that we see forming in the Hong Kong office market, we think Central is expanding into Greater Central, which already incorporates Admiralty and Southern Wanchai, and believe that, over time, it could incorporate Sheung Wan as well. We see West Kowloon as currently a market supplementing Central and think this is likely to be its position in the future. We expect Central to mainly house financial and related industries and expect rental levels for most prime buildings to be HKD80/sq ft plus.

We see the four established districts – Wanchai, Causeway Bay, Tsimshatsui and Hong Kong East – as the second layer after Greater Central, and we believe these areas serve as alternatives to multinationals which do not think they have to be located in Central. We forecast the total net floor area (NFA) of these four areas combined to reach 24.8m sq ft by 2019 which would make it similar to Greater Central in terms of total size. We expect rental levels for prime buildings in this area to be in the range of HKD40-90/sq ft over time, and see considerable room for a rental uplift for those prime buildings in the area.

CBD2 is unlikely to replace Central

Meanwhile, there has been much talk about Kowloon East – the third layer – ultimately replacing Central as the CBD. We do not subscribe to this view. Hong Kong East's experience illustrates that the transformation of an area into a commercial hub is a process that takes many decades, and we do not think Kowloon East will be an exception. We also doubt whether the whole of Kowloon East is suitable for the finance industry (the Central office segment's main focus), and whether the landlords in Kowloon East and indeed the government have such aspirations. That said, we see Kowloon East as a very important component of the Hong Kong office market, and believe it may help to address many issues in the Hong Kong Grade-A office market.

For the fourth layer, we refer to areas like Mongkok, Hunghom, Tsimshatsui East, Kwai Chung and Tsuen Wan, and Cheung Sha Wan, which we think are additional and likely cheaper alternatives to the most established areas for corporations.

For the fifth layer, we refer to areas like Tuen Mun and Shatin, which we think lack the critical mass needed to be office locations but may meet the needs of certain companies.

One issue faced by Hong Kong as a commercial hub is that start-up costs are prohibitively high for many trades, especially multinationals that generally want tens of thousands of square feet of space to start with. In our view, the office space in East Kowloon is well suited to companies that have a lower margin per employee (such as insurance, shipping, trading, etc.), and we expect many multinationals that require large floor plates and engage in trades with lower margins to relocate to this area over time. We expect rents for prime buildings in East Kowloon to be in the range of HKD25-40/sq ft over time.

We envisage that, over time, the total stock of office space in this area will be similar to that of Greater Central and the four established core areas. However, we think the target corporations of these three areas are different and do not see Kowloon East in direct competition with the other districts. Indeed, we believe that, in many ways, Kowloon East and the four districts complement each other.

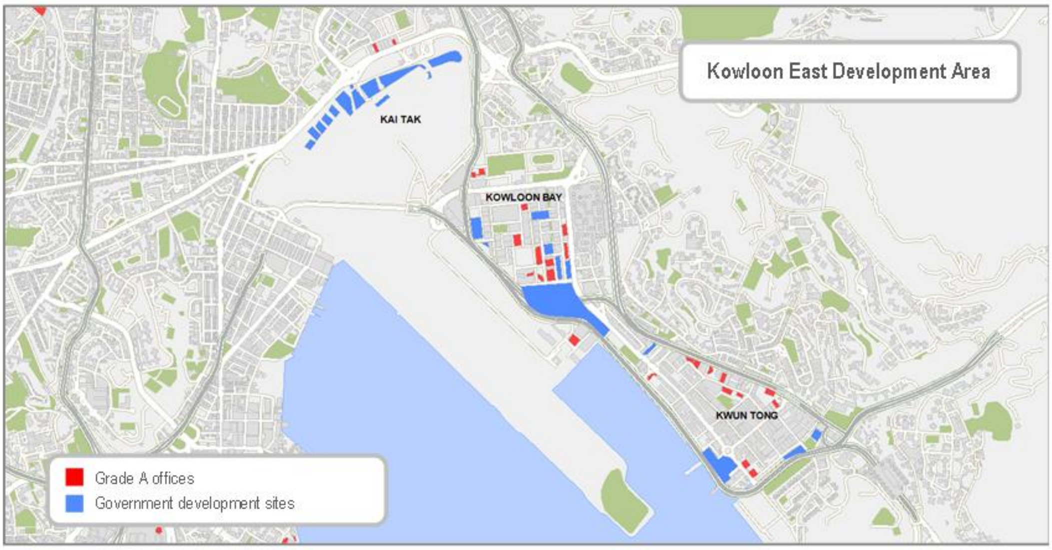
The Kowloon Bay cluster in Kowloon East

Source: Daiwa

The Kwun Tong cluster in Kowloon East

Source: Daiwa

The Kowloon East Development area



Source: CBRE Research

Chapter 6

Retail property: the four districts and the emerging suburban malls

A retail property market undergoing transformational change

In our opinion, the Individual Visit Scheme (IVS) is transforming Hong Kong's retail property sector by expanding the "catchment area" of retail properties from just the city's population to, potentially, almost the entire population of China. In the eyes of international retailers, there could be a quantum leap in the scale of Hong Kong's retail property market, from one addressing some 7m people to one reaching 1bn or more consumers.

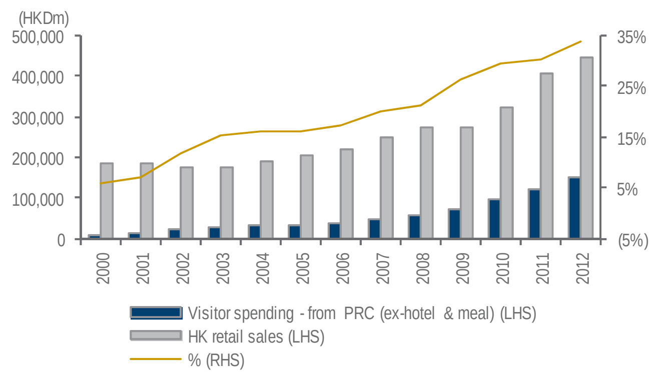
This process is unlikely to happen overnight. Business expectations tend to overshoot from time to time, as developments in the real-estate sector often do not keep pace with the progress envisaged in board rooms. Still, if the underlying structural trend is genuine, then it would likely reassert itself after periods of consolidation.

Catchment area expanded from 7m people to 100m or more

In our opinion, there has already been a transformation in the importance of the Hong Kong retail market to international retailers, as the city has gone from being a small market in Asia to one used by international retailers as the first step in penetrating the China market. We think this change in perception started in earnest a few years ago and has reached a point from which there is no turning back.

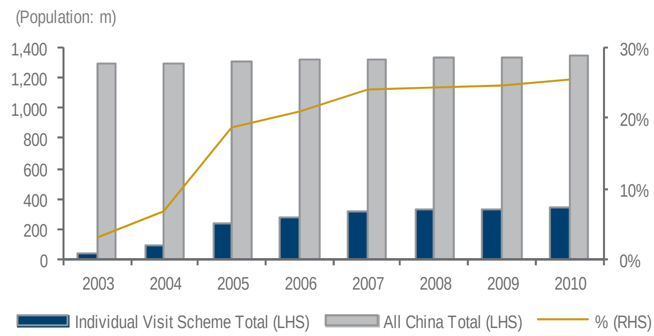
Granted, there will be adaptations and adjustments from time to time. One recent development we have seen is that some international retailers are consolidating their number of stores, closing outlets that are delivering only average performances and ploughing back resources into flagship stores that are viewed as strategically important for the long term. But, on a five-year view, we believe that international retailers will continue to treat Hong Kong and China as priority markets.

Retail sales growth and contribution from Mainland China tourists



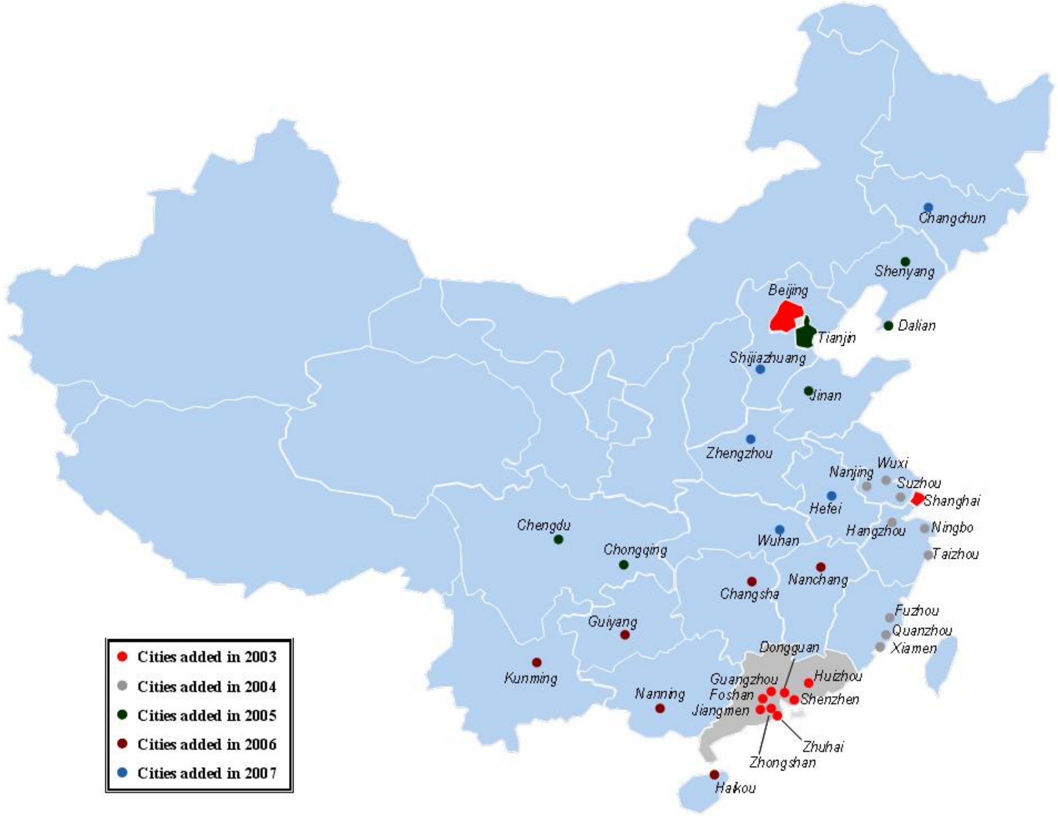
Source: CEIC, Daiwa

Individual Visit Scheme coverage



Source: CEIC, Daiwa estimates

Cities included in the Individual Visit Scheme (IVS)



Source: Daiwa

Considerable room to expand, both horizontally and vertically

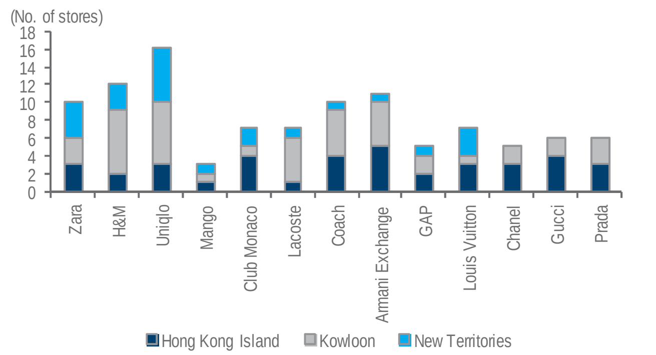
In our opinion, a quantum leap in the scale of Hong Kong's retail property sector is in the making. Even allowing for the periodic adjustments that typify the sector, we think the broader trend is ongoing. As we see it, the process will continue to play out by changing the scale of established retail districts and altering the profile and positioning of currently lower-tier districts.

Established retail areas likely to become larger in size

The existing stock of prime retail properties in Hong Kong's established retail districts is too small to accommodate the scale of retail spending that could theoretically take place in Hong Kong, in our view. As such, the sharp rise in retail spending in Hong Kong in recent years has significantly boosted retail sales in prime shopping malls and high-street stores in Hong Kong's major retail districts. From our observations, the ground-floor spaces of Hong Kong's major retail districts are now filled with the shops of major international brands, many of them flagship stores which occupy several storeys. In the past, a shop of 2,000-3,000 sq ft would be considered large in a local context; but we are now starting to see shops of 5,000-6,000 sq ft and more.

We think one consequence of the expansion in the catchment area of the Hong Kong retail sector is that the existing stock of prime retail properties in established districts cannot cope with the demand. As such, we see ample scope for the established retail districts in Hong Kong to expand, both horizontally (into what used to be regarded as fringe areas) and vertically (through the conversion of residential or office space on higher floors into retail use).

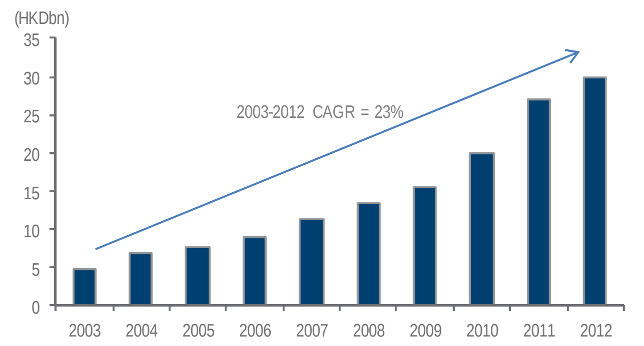
Number of stores of international retailers (2012)



Source: Savills, Daiwa

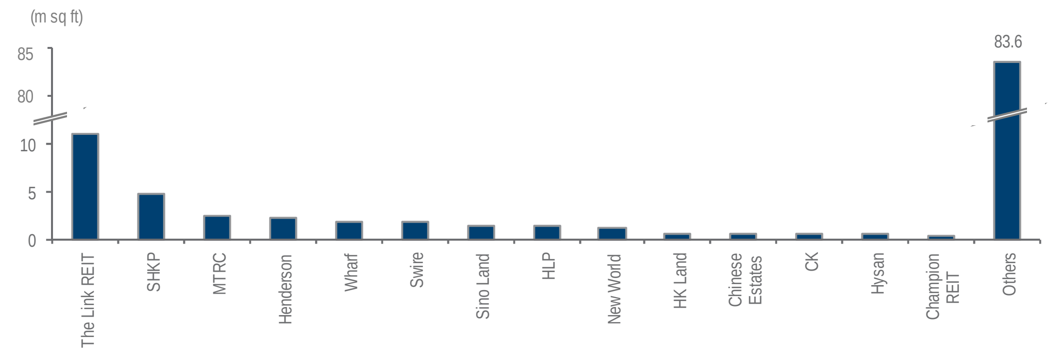
Note: *Excluding stores in department stores, duty-free stores, and the departure hall at the airport

Retail-sales revenue in Harbour City



Source: Wharf Holdings, Daiwa

Ownership of retail property assets (2012)*



Source: Companies, Daiwa estimates

Note: *In terms of internal floor area

The four established retail districts and their growing scale

As we see it, the established retail districts in Hong Kong are Causeway Bay, Tsimshatsui, Central and Mongkok. Of these, Tsimshatsui has so far been the biggest beneficiary of the surge in retail spending by people from Mainland China, with Harbour City riding this trend to become the number-one mall in the world in terms of achieved retail sales.

While Harbour City is likely to remain the strongest-performing mall in Hong Kong for the foreseeable future, and Tsimshatsui the retail district with the highest achieved retail sales, we think Tsimshatsui needs to overcome some challenges before it can become an integrated retail hub along the lines of London's West End.

As it stands, Tsimshatsui's retail presence comprises three separate markets: 1) Harbour City is almost a standalone market in its own right, 2) the area west of Nathan Road can be considered as one market, and 3) the area east of Nathan Road can be considered as another market. Outside of Harbour City, ownership of the retail space in Tsimshatsui is dispersed among several landlords and several retail mails are strata-titled.

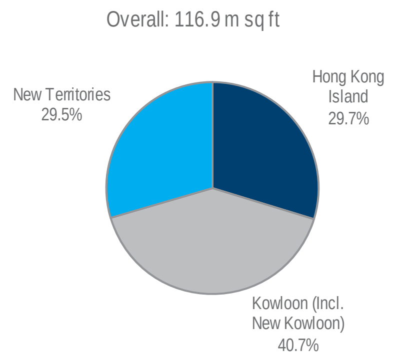
All four areas are changing; Causeway Bay looks the most balanced

In comparison, the development of Causeway Bay looks more balanced and, in our view, the area may have more potential than Tsimshatsui in the long term to emerge as a mega retail hub. We think various new developments (including the completion of Hysan Place and the asset-enhancement initiatives [AEI] undertaken at Times Square and across Hysan Development's entire portfolio, etc.) have elevated the importance and potential of Southern Causeway Bay, which we see as well on its way to becoming an integrated retail area. Over time, we expect Southern Causeway Bay to merge into Northern Causeway Bay to form one large-scale integrated retail hub.

Other established retail districts in Hong Kong are also undergoing changes. Central has not had a strong retail component historically, but Hongkong Land has added many prominent international retailers to its Central portfolio since the early 2000s. Consequently, we are seeing Queen's Road East emerge as a more prominent area for retailing, and we believe that Central will develop more of a retail flavour over time.

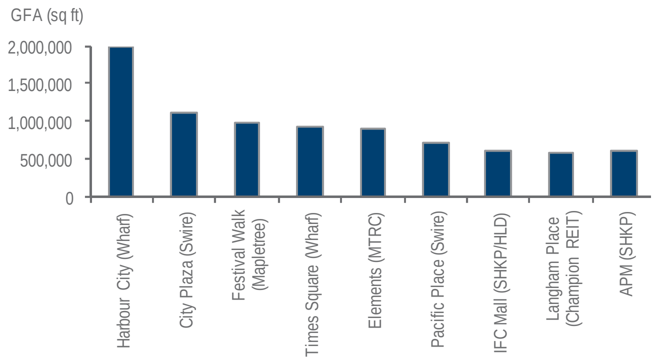
Similarly, we are seeing changes in the retail landscape in Mongkok. While Mongkok was formerly known as a favourite of local shoppers seeking mass-market products, the area is increasingly skewing towards the youth segment, which favours trendy items.

Retail floor area breakdown by district (2012)



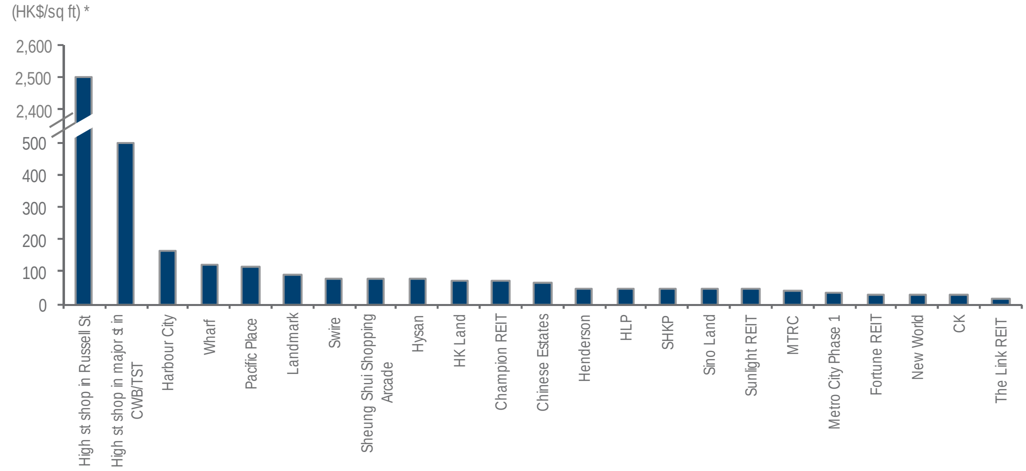
Source: CEIC

Major retail malls in urban areas



Source: Companies, Daiwa estimates

Achieved rents of major retail properties in Hong Kong (2012)



Source: Companies, Daiwa

Suburban malls: the rising stars

Historically, the New Territories has not been a major component of the Hong Kong retail property sector. In terms of population, it is the largest of the three retail districts in Hong Kong. Yet, in terms of retail floor area, it is smaller than Kowloon and Hong Kong Island.

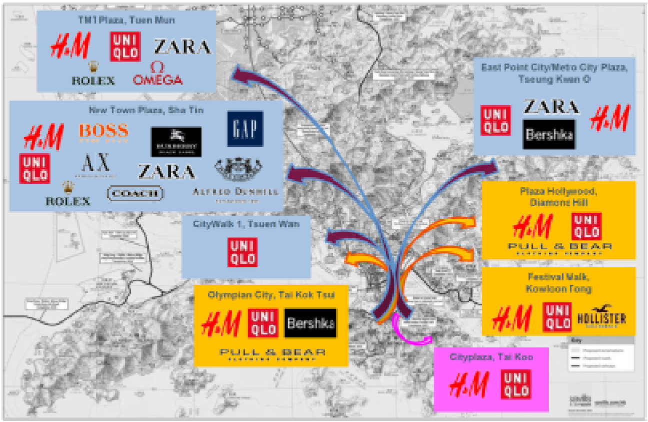
In Singapore, there is not a significant difference between rents in suburban areas and Orchard Road. In Hong Kong, however, there is marked contrast between rents in suburban areas and prime areas. Indeed, among major retail markets, Hong Kong stands out for having one of the largest differences between the achieved rents of top-tier malls and those of lower-tier malls. A case in point is the achieved rents in Russell Street, Causeway Bay, which can run to HKD2,500/sq ft, or more than 100x those for bottom-tier retail space in Hong Kong.

Many international retailers have accepted the New Territories

The existence of a large pool of consumers across the border, together with the growing importance of cross-border shopping, is changing the retail property landscape in Hong Kong. Prime retail space in Hong Kong's urban areas has been highly sought after in recent years, and commercial pressures now dictate that retailers need to find alternatives. Suburban malls are becoming increasingly important, and top-tier suburban malls such as New Town Plaza (Shatin) and Tuen Mun Town Plaza (Tuen Mun) are attracting more prominent international retailers and, in the process, moving up-market.

We believe the transformation of suburban malls is a theme that will continue to play out over the coming years, and this process will likely centre on Shatin, the North, Yuen Long and Hung Shui Kiu, Tuen Mun and Tseung Kwan O.

International retailers' expansion into the New Territories

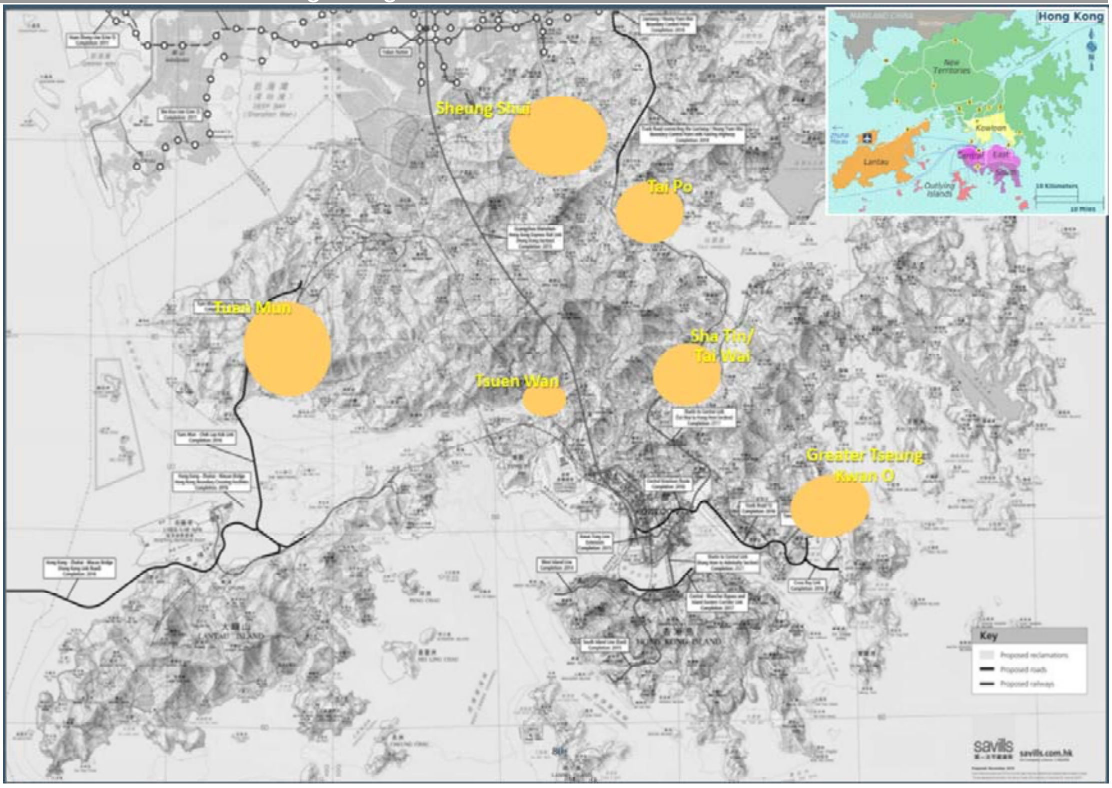


Source: Savills

Suburban malls in Tseung Kwan O

Source: Savills

Suburban malls in Hong Kong



Source: Savills

Chapter 7

The unique monetary backdrop of Hong Kong

US interest rates, China economy – an unusual combination

The monetary backdrop tends to be a key factor in the development of a real-estate market. To chart the development of the Hong Kong property sector, it is instructive to look back to 1983, when Hong Kong first adopted the peg between the local currency and the US dollar. This policy decision has had far-reaching consequences for the city and its real-estate market.

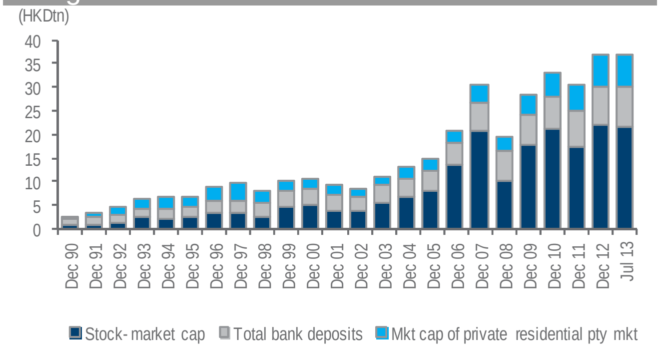
The dollar peg gave Hong Kong an unusual complexion, in that the city was largely influenced by US interest rates and the state of the China economy. In other words, Hong Kong, with an area of just 1,000 sq km or so, became tied to the fortunes of two mega-economies – part of the US in a monetary sense and part of China in terms of the real economy.

Hong Kong’s dual reliance

The US and China economies are, of course, fundamentally and structurally different in many respects, and they are at different stages in their development. This dual reliance on US interest rates/China economy is seldom seen in other markets. On top of this, because of the dollar peg, Hong Kong is an economy where the exchange rate against the greenback is fixed and interest rates have to follow those in the US, so asset prices become the main avenue for adjustments to accommodate changes in the economy and capital flows.

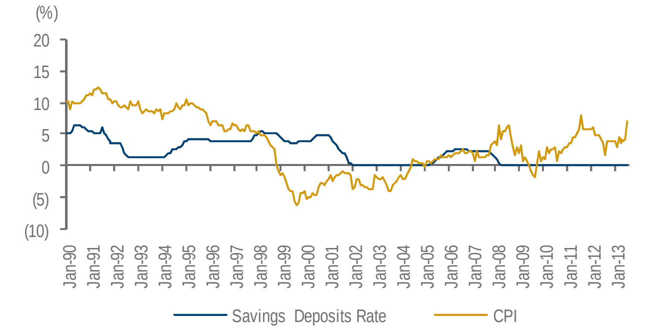
Large swings in asset prices should therefore be expected. Experienced market participants in Hong Kong are well aware of the likely volatility in prices, and have been doing what they can to manage such swings in the Hong Kong property market by refraining from taking on leverage, on our reading.

Size of the three main asset classes in Hong Kong



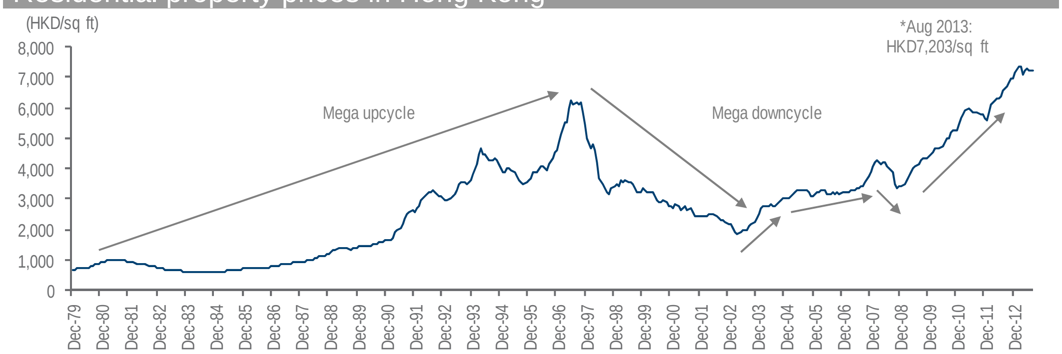
Source: CEIC, Midland, Daiwa

Monetary backdrop for Hong Kong residential property



Source: CEIC, Daiwa

Residential property prices in Hong Kong



Source: Midland, Daiwa
Note: *provisional figure

How vulnerable is Hong Kong to a rise in US interest rates?

From 1983-1997, both factors worked in favour of the Hong Kong Property Sector, pushing prices to record levels. Then came the financial turmoil in Asia and the attacks on the Hong Kong Dollar's peg to the US Dollar, which resulted in interbank rates rising to more than 20% at one stage.

In the ensuring six-year downturn in the Hong Kong property market (4Q97 to mid-2003), the major developers deleveraged and trimmed their landbanks. Interest rates in the US began falling after the September 2011 terrorist attacks. US interest rates started to normalise after 2005, but the trend of hikes in the US stopped in 2007, and then the global financial crisis triggered another round of rate cuts and ushered in the Federal Reserve's policy of quantitative easing, which was emulated to varying degrees by Europe and Japan.

Hong Kong property prices have benefited from the low-interest-rate environment. But have exceptionally low interest rates really been the primary driver of the Hong Kong residential property market in recent years? One feature of the current property cycle in Hong Kong is that market participants seem to have been surprisingly prudent and restrained in their use of leverage.

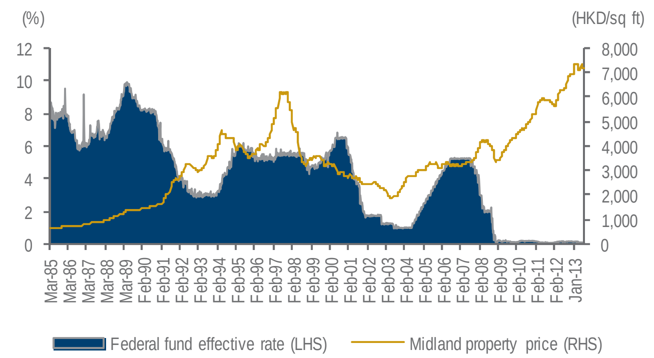
Illustrating Hong Kong's reliance on US interest rates

Government policies have played a role in restraining the leverage taken on by economic participants in many Asian countries, in our view. With the financial turmoil in Asia still probably fresh in their minds, many governments in Asia have taken radical action to prevent easy-money-driven asset bubbles from forming. They have done so chiefly by making it hard for the public to borrow significant sums of money.

We believe we are likely to see a reversal of the low-interest-rate environment soon. Still, we believe mortgage rates in Hong Kong of around 5% represent a critical threshold; rates below that level are likely to be seen as merely a normalisation of interest rates, or simply as higher rates under a still-low interest-rate environment. We note that mortgage rates in Hong Kong did touch 5% in 2007, when the Federal Reserve was seeking to normalise US interest rates. But property prices in Hong Kong were stable at the time.

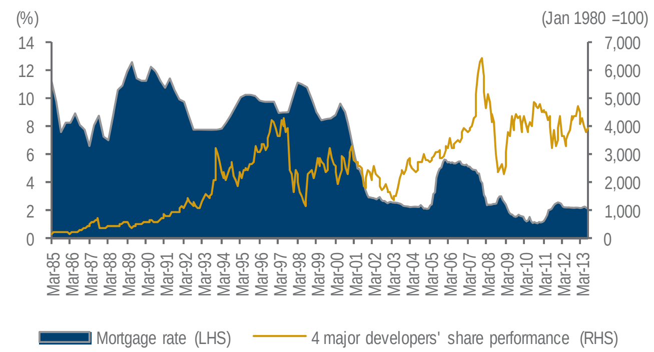
Since February 2013, the Hong Kong Monetary Authority has required that banks apply a 300bp stress test when approving new loans. Hence, while the nominal rate for a new mortgage may be 2.2%, it will have been approved on the basis that the mortgage rate is 5.2%.

US Fed funds rate versus Hong Kong residential property prices



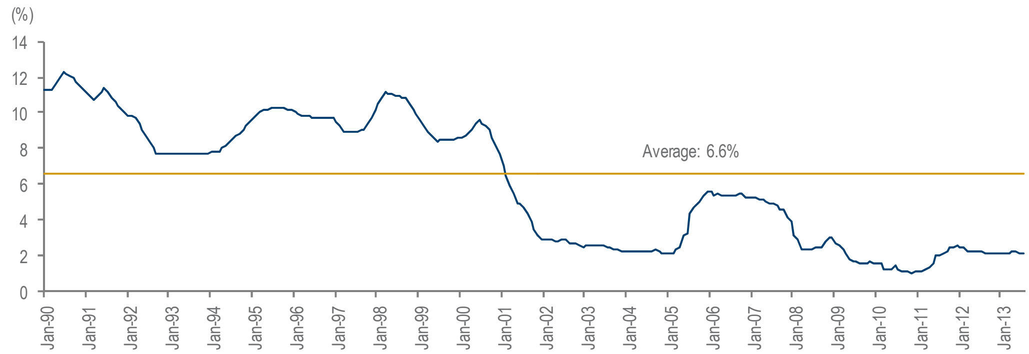
Source: CEIC, Daiwa

Hong Kong mortgage rates and share-price performance of developers



Source: CEIC, Daiwa

Mortgage rates in Hong Kong



Source: CEIC, Daiwa

Is there over-borrowing in Hong Kong?

Mortgage loans outstanding in Hong Kong started to rise again since 2009, while mortgage loans outstanding as a proportion of GDP have been increasing in recent years. But, these indicators do not necessarily mean that the Hong Kong property market is characterised by over-borrowing.

In terms of the size of its asset market relative to GDP, the Hong Kong property market long ago surpassed that of Switzerland, and now has one of the highest such readings in the world. In this context, we think the rise in mortgage loans outstanding in Hong Kong could indicate only that the transacted value of units in Hong Kong is high and that buyers of new units do not all pay in cash. It is important also to take into account the value of the underlying property assets for which mortgage loans are granted.

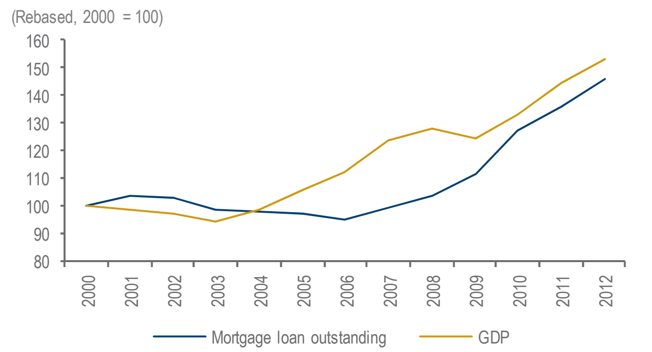
From this perspective, we think the case can be made that there is no over-leverage in the system. Mortgage loans outstanding in Hong Kong currently represent less than 20% of the value of the underlying assets, and this is consistent with the findings of a government survey showing that over 60% of residential units in Hong Kong are "without a mortgage".

The system as a whole appears far from being over-leveraged

The emerging picture is that there are people in Hong Kong who regard property purchases simply as a way of storing wealth, and this group has been quite active in recent years. One feature of the Hong Kong residential property market is the rise to prominence of a group of buyers (mainly comprising wealthy individuals from Mainland China and Hong Kong) who do not use a lot of leverage, preferring instead to shift their wealth from other asset classes into residential property.

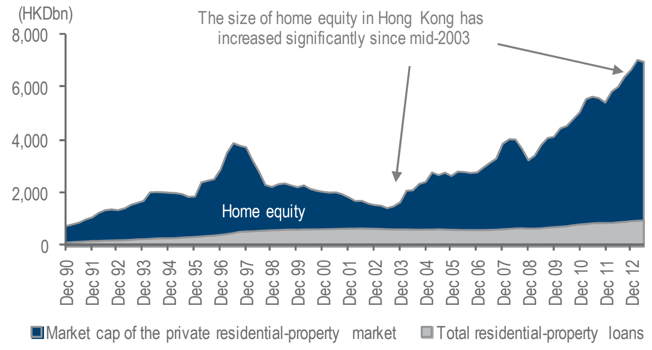
The rise in residential property prices over recent years appears to have been caused by wealthy individuals rebalancing their portfolios in favour of Hong Kong, rather than by "ordinary people" leveraging up to buy their desired units.

Mortgage loans outstanding versus GDP in Hong Kong



Source: CEIC, Daiwa

Mortgage loans outstanding versus market value of underlying assets in Hong Kong



Source: CEIC, Daiwa

Evolution of mortgage loans outstanding in Hong Kong

(HKDm)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	7M13
Transaction value in																		
- primary market	72,119	113,378	119,679	83,812	72,500	68,451	74,512	78,549	101,024	91,442	52,402	113,971	68,338	112,961	127,695	130,990	132,207	41,596
- secondary market	319,799	563,747	155,031	135,752	110,777	91,291	78,908	71,452	173,796	215,564	177,488	318,360	276,129	312,932	433,044	311,839	323,003	133,552
Total	**391,918**	**677,125**	**274,710**	**219,564**	**183,277**	**159,742**	**153,420**	**150,001**	**274,820**	**307,006**	**229,890**	**432,331**	**344,467**	**425,893**	**560,738**	**442,829**	**455,210**	**175,148**
New loans drawn	162,957	256,306	112,414	119,205	116,462	106,515	98,545	79,482	133,548	142,814	115,117	173,508	184,754	199,295	324,216	227,775	191,854	101,089
New loans approved	182,022	274,462	125,849	141,831	137,264	122,144	107,924	84,794	155,720	156,879	140,637	213,884	224,287	311,416	413,863	270,300	256,890	124,700
Change in total mortgage loan outstanding	57,731	95,043	33,869	18,906	43,457	6,817	5,212	(11,493)	5,631	5,201	(3,711)	28,497	29,776	53,311	99,311	60,821	67,212	30,108
Total mortgage loan brought forward	272,695	330,426	425,469	459,338	478,244	521,701	528,518	533,730	522,237	527,868	533,069	529,358	557,855	587,631	640,942	740,253	801,074	868,286
Total mortgage loan carried forward	**330,426**	**425,469**	**459,338**	**478,244**	**521,701**	**528,518**	**533,730**	**522,237**	**527,868**	**533,069**	**529,358**	**557,855**	**587,631**	**640,942**	**740,253**	**801,074**	**868,286**	**898,394**

Source: CEIC, Midland, Land Registry, Daiwa

Chapter 8

Hong Kong property companies: an asset class on its way to establishing a new identity

Are Hong Kong property companies a separate asset class?

Some Hong Kong property companies are among the largest property companies in the world in terms of market capitalisation, asset base, and profit level. However, unlike in many property markets overseas, there are few medium-sized players. As a result, we estimate the listed property sector of Hong Kong accounts for about 10-15% of the global real-estate indices in terms of weighting. While not small, this weighting is not large enough to appeal strongly to investors who invest on a global basis.

The structure of the Hong Kong Property Sector may also affect the level of investment capital the sector attracts. In developed markets such as the US, Europe and Australia, many of the real-estate companies are REITs. By contrast, REITs forms a relatively young and small segment of the Hong Kong property industry. Elsewhere, many property companies concentrate on one type of product, eg, pure home builders and pure office builders. They also are either mainly developers of property for sale or landlords that hold and develop rental properties for lease.

Hong Kong property stocks may be outside the comfort zones of some investors

While most of the Hong Kong property players started out as developers of residential properties, many have also been expanding their rental portfolios in both office and retail properties, resulting in the companies becoming integrated developers with varying exposure to the residential, office, and retail property sectors.

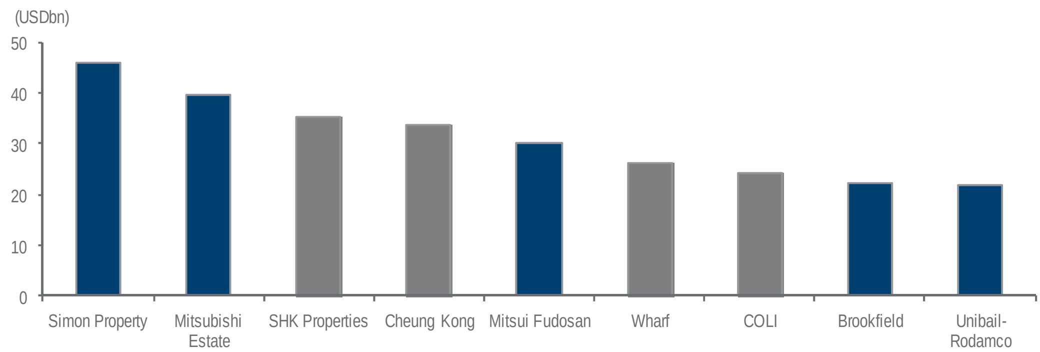
Meanwhile, many property companies in the city have acquired stakes in utilities companies, probably because this was an attractive way to get land in the past. These interests have now become an integral part of their business.

Cheung Kong's business model could be described as one in which it makes use of the profits derived from residential property sales to acquire undervalued companies. It has then used Hutchison Whampoa as the platform to build and invest in a range of other businesses around the world.

In this light, the Hong Kong property companies may be seen more as long-term builders of family wealth than specialists focused on certain property segments or markets. While their principal business is property, their main focus has been returns and NAV over the long term: and they are prepared to move across different types of property businesses or even enter into new businesses as long as the return profile looks attractive.

This approach is not so common among property stocks elsewhere. As such, we believe the Hong Kong property stocks do not readily fit into a category that is familiar to, or comfortable for, global investors.

The world's major property stocks in terms of market capitalisation



Source: Bloomberg, Daiwa
Note: as at 11 September 2013; COLI = China Overseas Land & Investments

A different type of business model

It is sometimes said that real-estate markets in the developed world are quite institutionalised, with many of them REITs and/or run by professional managers. In comparison, the listed property companies in Asia and Hong Kong are mainly family companies, and are generally still run by family members.

Governance is a high priority, especially for long-term funds from overseas, and it is difficult for them to know much about individual families in Asia. However, many Hong Kong property companies have more than four decades' experience in the industry and there is a high level of management continuity.

The Hong Kong property companies' model seems unusually prudent

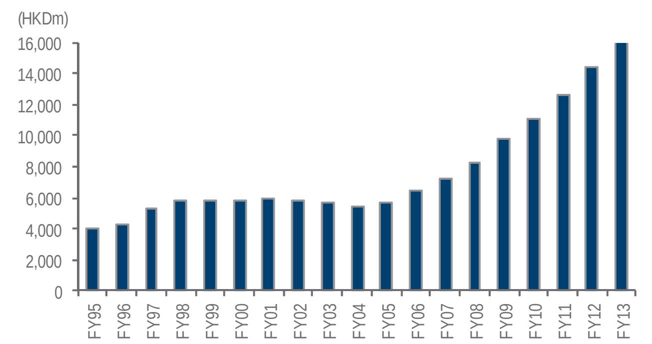
The Hong Kong property market has been characterised by turmoil and great volatility over the past few decades, and so the property companies have survived some of the sharpest downturns in property markets anywhere in the world. Compared with real-estate companies elsewhere, the Hong Kong players tend to use more equity in financing business expansion; some may say it has been over-used. For all the criticism, though, the Hong Kong property companies are generally financially strong.

This is an anomaly in global property. Real estate is regarded by some investors and industry players as an industry that is all about financial leverage, and it is common for many real-estate companies to pursue business growth through making active use of financial leverage.

In comparison to many property companies worldwide, the Hong Kong property companies appear unusually prudent and conservative when they come to the use of debt. The major property companies currently have net-gearing ratios of not more than 20% (as of end-June 2013), with Sino Land in a net-cash position. Most of the Hong Kong players look sufficiently financially sound that they should be able to survive even the sharpest property market downturn, on our view.

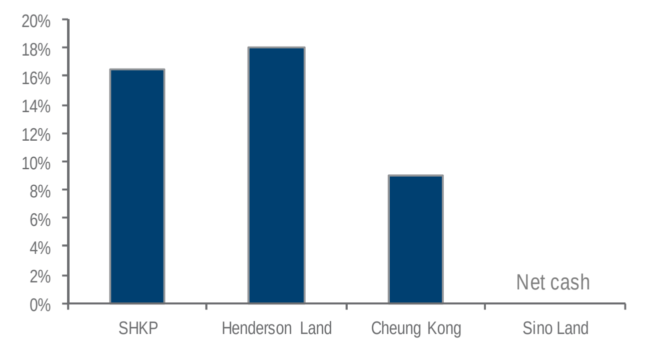
Another point to note is that the history of Hong Kong property seems to suggest that the ability of property companies to have capital to buy land during market downturns is very important in the times ahead, which may reinforce their general emphasis on increasing recurrent income and keeping gearing under control. In short, the Hong Kong property companies seem to be practicing a kind of business model that is quite different from most others in the industry.

Gross rental income of SHK Properties



Source: SHK Properties, Daiwa
Note: financial year end 30 June

Net gearing ratio of major property companies in Hong Kong (end-June 2013)



Source: Companies, Daiwa

Moving from being asset traders to being asset managers

Most of the large Hong Kong property companies were involved in manufacturing prior to the 1960s. They took up the opportunities created by the collapse of land prices following the riots in 1967 to build up their landbanks, and then listed on the Hong Kong stock market over 1970-72 to obtain extra capital to finance further expansion. In general, they initially did not have strong capital bases, and needed to rely on residential property development to get the cash flow to finance their expansion. Given this, most of them focused on asset turnover and property sales, especially in the early years.

Hong Kong has some high-quality asset managers

That said, there are a few companies in Hong Kong that have a rich endowment in terms of having sizeable landbanks. These include Hongkong Land and Wharf Holdings, both of which have histories of more than 100 years. Both own large sites with redevelopment value, and hence do not have to tie up capital to fund the acquisition of a large-scale site in the city centre, which is often required by premier commercial property projects.

Swire Properties's position is somewhere between that of Hongkong Land and the local Hong Kong developers. While the company's ownership of a large shipyard in Quarry Bay, on Hong Kong Island, has been critical to it building a large-scale commercial property portfolio in Hong Kong East, the land on which it built Pacific Place (a mall, hotel and office development) was acquired in auctions through open bidding.

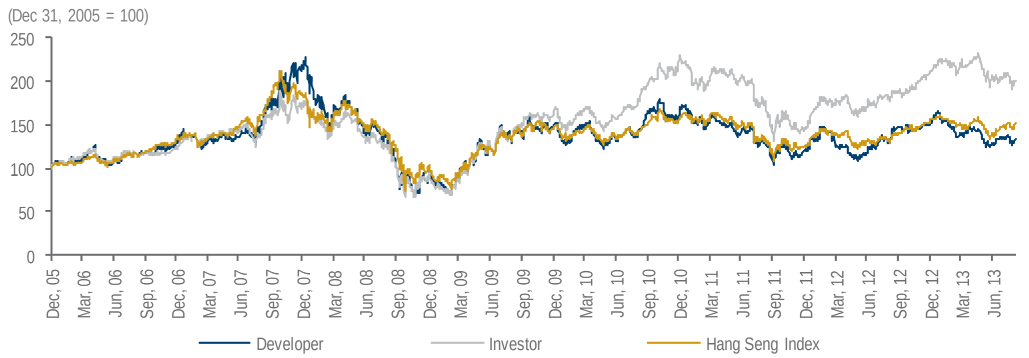
We believe these three companies pay great importance to the management of their property assets, and that other developers have been moving in this direction in recent years. The Asia financial crisis in 1997 showed companies that recurrent rental income could save them during an unusually difficult time, and that well-managed shopping malls provided the most reliable sources of cash flow among all property asset classes.

Property companies in Hong Kong have generally been placing greater emphasis on asset management since the early 2000s. The trend was probably reinforced by the listing of The Link REIT (2005) and other REITs, which showed the potential value that could be created for a property through asset-enhancement initiatives (AEI).

Overall, we think Hong Kong has some high-quality asset managers. Are Hongkong Land's Central portfolio and Swire's Pacific Place portfolio really managed in a way inferior to the management style favoured by the premier names in global property, such as Simon Property, Westfield, and Boston Properties? Arguably not, yet in terms of valuation the premier global property names have for many years tended to trade at premiums to their NAVs, whereas Hongkong Land and Swire Properties have generally traded at discounts to their NAVs, and the trend is to place a greater emphasis on this.

We do not believe investors have fully recognised this favourable change in the management of Hong Kong property companies.

Stock-market performance of property investors versus property developers in Hong Kong



Source: Datastream, Daiwa

Will they become the largest players in commercial properties in China?

Apart from having rising recurrent income, the Hong Kong property companies generally have expanding their businesses in China. Several companies established presences in China property in the the late 1980s or early 1990s. However, the returns achieved on projects completed in the 1990s were not particularly attractive, and so many of the companies did not increase their China investments from the mid-1990s onwards.

The situation started to change in the mid-2000s, as the listings of several major players in China property highlighted the profit potential in that market. For some Hong Kong property companies, such as Wharf Holdings, the invested amount is sizeable, at HKD100bn. Importantly, we believe the China investments of many of the Hong Kong property companies have finally reached the point where they are starting to provide a meaningful profit contribution. This was clear in the FY12 results, and continued to be the case for the 1H13 results.

Hong Kong property companies look on track to become major players in Mainland China

Many Hong Kong property companies are now among the largest players in the commercial property sectors of China's major cities. We expect them to be able to maintain their positions for the near future, given the amount of high-quality office and retail space in the country. In addition, it is likely to take time for the local players to master the skills related to managing large-scale commercial property projects and to have the large capital bases needed to take on these kinds of projects.

In short, we see significant value-creation potential from prime commercial properties in China. Most importantly, it does not appear to us that the stock market has yet assigned any major value to Hong Kong property companies' investments and assets in China. Any change in this should bring an uplift to the valuations of Hong Kong property companies, in our view.

Gross rental income from China (FY12)

	Interim/ final	Dec 11 (HKDm)	Dec 12 (HKDm)	YoY change
China gross rental income				
Hang Lung Properties	F	3,014	3,526	17.0%
SHK Properties	I	743	987	32.8%
Swire Properties	F	782	1,373	75.6%
Henderson Land	F	915	1,162	27.0%
Wharf Holdings	F	796	1,005	26.3%
Kerry Properties	F	893	965	8.1%
New World Development	I	173	279	61.4%
Total		7,315	9,297	27.1%

Source: Companies, Daiwa

Gross rental income from China (1H13)

	Interim/ final	Jun 12 (HKDm)	Jun 13 (HKDm)	YoY change
China gross rental income				
Hang Lung Properties	I	1,475	1,701	15.3%
SHK Properties	F	1,614	2,067	28.1%
Swire Properties	I	652	784	20.2%
Henderson Land	I	556	644	15.8%
Wharf Holdings	I	479	536	11.9%
Kerry Properties	I	471	521	10.6%
New World Development	F	461	TBA	n.a.
Total		5,708	6,253	19.2%

Source: Companies, Daiwa

Note: New World Development has not yet announced FY13 results

How are Hong Kong property stocks viewed from afar?

There are many possible explanations for the high NAV discounts for the Hong Kong property companies. The high volatility in asset prices, the lower cap rates used to value property assets compared with other markets, family ownership and governance concerns, policy risks, bubble risks, fund-raising risks, differences in business models compared with international peers, and the absence of a take-over market for companies, are some of the reasons.

In this report, we have approached this issue from another angle, which is related to the evolution of Hong Kong's stock market. The city has had a stock market for more than 100 years, but for many years this was not a market in which institutional investors were the major players. Overseas securities houses started to come to Hong Kong in the 1980s, and gradually the city came to be viewed by institutional investors as one of the emerging markets for stocks.

The disconnect in valuations may go back to the evolution of Hong Kong's equity market

However, as all the emerging markets combined did not account for a large weighting in global stock indices, the Hong Kong stock market was not even close to being seen as a major component of global funds. Indeed, whether one is right or wrong in having exposure to Hong Kong or not doesn't really matter to the global funds.

As such, most institutional investors active in Hong Kong property stocks in the past were Hong Kong, Greater China or regional funds. In general, stock markets in Asia are influenced by short-term news flow and trading, and it was uncommon for investors to take multi-year, bottom-up views of companies. Historically, many institutions have tended to view Hong Kong property as a relatively high-beta play on the overall economy. In recent years, though, we have seen signs of change, with some global value funds taking sizeable stakes in selected Hong Kong property companies.

Meanwhile, there has been a significant expansion in the market capitalisation and sector choices for investors in the Hong Kong equity market over the past 10 years. Prior to the IPOs of mega-sized China companies in recent years, investors managing Hong Kong funds could only choose from the banking, property, conglomerates, and utilities sectors. The choice now includes China banks, oil & gas, aviation, transport, telecoms, Macau gaming, and China property, which have become sizeable sectors in terms of market capitalisation over recent years.

While these mega-sized IPOs have quickly increased the market capitalisation and funds raised from IPOs in Hong Kong to the levels seen in the world's top stock markets, turning the Hong Kong stock market into one that ranks highly globally in terms of secondary-market trading will take much longer, in our view.

We think one issue is that Asia's emerging markets seem to have lost some of their appeal since the Asia financial crisis of 1997. More broadly, investors' sentiment towards China and China property stocks can swing widely. All things considered, there may not be a large enough pool of money dedicated to the secondary trading of Hong Kong stocks, much less to Hong Kong property stocks.

There may not be enough anchored money dedicated to the Hong Kong market

During the global financial crisis in 2008, Hong Kong stocks were among the first to be sold, probably reflecting the fact that Hong Kong is the largest, most liquid of the emerging markets, and that capital from Western markets tends to be withdrawn from emerging markets when there are problems at home. Also, following the global financial crisis, there appears to be heightened risk aversion within the investment community, and several funds have shifted money from equities to bonds. Dedicated equity funds may tend to stay in developed markets rather than invest outside them. This is another challenge facing the valuations of many stocks in Hong Kong, in our view.

We believe listed property stocks in Hong Kong appear to face an identity issue, which could be related to the evolution of the Hong Kong stock market and how the global investment community views China and emerging markets. Ultimately, this could give Hong Kong property stocks a new dimension.

Some investors in developed markets have a tradition of taking multi-year, bottom-up views on companies, and compare property stocks across markets and against the physical properties as well. On such a basis, we think Hong Kong property companies could appeal.

As the Hong Kong stock market becomes more globalised, we think the Hong Kong property companies could see favourable changes in their valuations if more investors focus on their valuations relative to those of their global peers.

Could share buybacks help address the issue?
We believe there is a disconnect between the physical property markets in Hong Kong and the share prices of the Hong Kong-listed property stocks. Relative to the current market values of the underlying property assets, the Hong Kong property stocks seem inexpensive.

The Hong Kong property companies appear to be among the world's most experienced and prudent real-estate players, and have a proven ability to weather severe downturns in the sector, which we think is a positive point for long-term investors. They have demonstrated considerable skill in growing their recurrent rental income in Hong Kong and nurturing their China businesses, into which they have put tens of billions of dollars – they are the owners and managers of some of the most prime commercial property assets in the country and are improving in terms of managing residential property business in China. They generally have provided increased transparency to investors and have been raising dividends in recent years.

Taken together, these factors should make the Hong Kong property stocks more appealing to the investment community, giving a potential driver for the hidden value in these stocks to be unlocked, in our view.

That said, the high NAV discount that Hong Kong property stocks currently trade at (48% on average based on our end-2013E NAV) is not a new phenomenon, and unlocking it is unlikely to be straightforward. We believe there needs to be a mechanism to narrow the disconnect. One way for Hong Kong property companies to reduce their NAV discounts could be to sell non-core assets and use the proceeds to buy back shares or (in the case of REITs) units. Although share buybacks tend to be seen in developed markets as just one part of a robust approach to capital management, there is no real tradition of share buybacks in Hong Kong.

Granted, investors generally want to see companies create value by expanding their market share, successfully entering new markets, and moving up the value chain. Yet we believe that "arbitraging between the physical market and stock prices" can create value for a business and its shareholders, and should at least be considered as part of a capital-management regime. We see it as a safe and effective way to create value for shareholders, especially institutional investors which do not value the ownership of assets.

In our view, there is a tendency in the investing world to believe that Asia companies are not greatly concerned with equity value and are prone to over-using equity. We see this as one reason for the high NAV discounts of Hong Kong property companies, and believe that the companies could alleviate such concerns by using proceeds from sales of non-core assets to buy back their shares/units.

Few property companies in Hong Kong have adopted this strategy to date. Still, Sunlight REIT has articulated such an approach, and has so far sold a non-core asset and used the capital to buy back units. We see this as a positive step towards a change in approach by the sector as a whole.

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