Durham University
Student Investment Fund

Hongkong Land

Target Price:$5.5-$7.5

Current price:$3.77

Date:10/10/2020

Executive Summary

Our analysis leads us to recommend a long position in Hong Kong Land with a long-term price target of $7.21, a 87% upside as of 27/8/20. This price target is based on a set of conservative assumptions about the future performance of the company and the wider geopolitical region in which its properties are located.

Hong Kong Land (HKL) is a subsidiary company of Jardine Matheson Group which predominately generates revenue through rental income from its superprime office and retail portfolio in Central, Hong Kong's predominant CBD. It also has significant commercial holdings in Singapore and mainland China, and participates in the development of residential properties in mainland China.

Our valuation of HKL suggests that the intrinsic value of the company is significantly above its' current price. Our belief is that this mispricing exists because of several short term threats that have adversely affected HKL, which the market has overreacted to, and also several serious major long term threats to HKL's compatriots which HKL is less exposed to but has been brought down by.

The key risks to this investment are:

Downturn in the Chinese property market: Development properties are form a significant part of HKL's profits. Any downturn in the Chinese real estate market will have serious implications on returns for the capital invested in China.

Liberalisation of capital accounts: A liberalisation of China's capital accounts will cause both a crash in the Chinese RE market and make Hong Kong's role redundant, impacting the value of HKL's assets.

Jardine Matheson: Given JM's majority control of shares and lack of desire to sell, there is no incentive for (JM appointed) management to take measures that would be beneficial to share price, from reorganising as a REIT or share buybacks.

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Company information

Ticker:H78 (SGX)

Price:$3.77

12M High:$5.9

12M Low:$3.46

Shares outstanding:2334MM

Market Cap:$8.798 B

Major shareholders

Jardine Matheson	50.4%

Business Overview

Founded in 1889 by Sir John Keswick of the Jardine Matheson trading house, and majority owned by Jardine Matheson Group to this day, Hong Kong Land (HKL) has traditionally generated revenue through rental income from its superprime office and retail portfolio in Central, Hong Kong's predominant CBD. It is the area's largest landlord. In recent years, HKL have diversified into other property-related markets, including ownership of significant commercial holdings in Singapore and mainland China, and the development (and disposal of) of residential properties in mainland China.

The company generates steady, predictable returns through its' investment properties, which is then largely reinvested into financing of development properties. Management believes this provides HKL with a buffer against any downturns that may happen in developmental properties; while developmental properties ordinarily provide a greater ROI than investment properties.

HKL has a close relationship with other JM group companies, for instance renting to Mandarin Oriental for hotels and working with Astra Intl. on developing in the SEA region.

Business Strategy

Steady returns through investment portfolio

HKL aims to generate steadily increasing, predictable cashflows through its investment portfolio. They invest in extremely high-end office and retail properties located in prime locations of major Asian cities, predominantly in Hong Kong and Singapore. The defensive and predictable nature of this cashflow allows them to finance other projects without high leverage.

High ROI through development portfolio

Using its investment cashflows, HKL finances and develops high-quality residential developments predominantly in mainland China. Management aims to have a 18-month cash turnover period between purchasing land premiums and pre-sale of apartments, which results in a significantly higher ROI compared to investment properties, albeit with higher risk and uncertainty. Cash is continuously recycled into new residential projects, and due to restrictions on profit extraction from China it is likely the share of revenues attributable to this segment will continue to grow.

Focus on mainland China

Management has a stated focus on the mainland Chinese market, and aims to have roughly 60-70% of capital investment to be in mainland China over the long term. This is from a belief that the Chinese market is fundamentally strong and will sustain its growth, expanding opportunities for their high-end positioning, as well as the fact that much of their pre-existing talent is located in China

Investment Thesis and Risks

Our investment thesis is largely centered around the idea that HKL has been unfairly beaten down by perceived threats to its earnings, both short and long term. Therefore we have combined the thesis and risk factors. As we look at each risk, we will explore the real and perceived severity, as well as why we think the market is overreacting to these risks.

There are multiple factors that have negatively impacted HKL's share price in the past few years. In order of their perceived importance to us (from least to most), these are:

- **A short-term decline in retail rents due to Covid-19.**
- **Long term uncertainty over the future of Hong Kong as a premiere shopping destination for mainland Chinese consumers due to the social protests of the past year.**
- **A terminal decline in office rents in Central due to a trend of de-centralisation to cheaper, less prestigious areas of Hong Kong.**
- **A terminal decline in retail and office rents due to technological change accelerated by Covid-19.**
- **Increasing doubt about the sustainability of mainland China's real estate boom.**
- **Long term uncertainty over the future of Hong Kong as a gateway between China and the world, due to the geopolitical tensions between China and the US.**
- **Jardine Matheson not being incentivised to protect minority shareholder rights.**

These factors have combined to force HKL's share price firmly into deep value territory, trading at 0.48 P/B, with a dividend yield of 6% and adjusted P/E of 6.4. The market is pricing in significant long-term decline in income which has not materialised, and is unlikely to materialise. Our opinion of each of the factors above is as follows:

A short-term decline in retail rents due to Covid-19:

Hong Kong has had a world-acclaimed response to the Covid-19 pandemic, with world-leading infection rates and control. We believe that while Covid-19 has and will continue to negatively impact short-term retail income, the regions' pandemic response will continue to be outstanding and that Hong Kong will be one of the fastest areas to fully recover from the pandemic. HKL's strategy of giving tenants rental relief if needed is also having an inordinate effect on their financial statements, with related book value adjustments impacting nominal profits, and the goodwill built up by working with tenants not recognised.

Long term uncertainty over the future of Hong Kong as a premiere shopping destination for mainland Chinese consumers due to the social protests of the past year:

We believe that the main reason mainland Chinese consumers often go to Hong Kong to purchase luxury items is not because of its warm welcome (indeed, animosity between locals and mainland residents has been well-documented for years and had little effect on arrivals), but rather the favourable prices compared to purchasing the same products domestically or from other countries (where you have a 50% importing duty). We so no catalyst for the Chinese government to change its stance on their tax rates. However, if it does happen, HKL should be more shielded from rental declines than its competitors due to its location and reputation. It will likely see significant reductions in retail rents rather than an outright lack of tenants.

A terminal decline in office rents in Central due to a trend of de-centralisation to cheaper, less prestigious areas of Hong Kong:

Hong Kong is one of the most expensive real estate markets in the world, and Central, the traditional CBD where HKL owns the most centrally-located properties, is the most expensive area of Hong Kong. Despite the benefits offered to brands by being located in the most prestigious area of the city, recent years have seen increased de-centralisation, with countless major companies moving at least part of their operations out of the area to cheaper areas. Especially at risk are back offices, which are not client-facing and hence see no benefit to branding. While this is a threat, HKL has a stated policy of long-term co-operative partnerships with their tenants, and as a part of this policy offer significantly lower rents than competing offices. We believe this insulates them against this trend.

In addition, growth is likely to be driven by a surge in cash-rich mainland Chinese companies listing on the HKEX, with prestige being of critical importance to these companies in the face of heightened investor scrutiny over their financials.

A terminal decline in retail and office rents due to technological change accelerated by Covid-19:

Covid-19 has restarted a long-running debate over the future of shopping malls and offices in the face of a technological revolution. Our view is that while this may be true for certain segments of the market, HKL is insulated by its positioning – its extremely high-end retail branding is unlikely to move online as the in-store luxury experience forms a significant part of the value proposition; and WFH trends are unlikely to take hold in Hong Kong, where residential apartments are incredibly cramped. We view the biggest threat technology presents as enabling the de-centralisation trend, where back offices and front offices can work together fine despite being located in different areas of the city.

Increasing doubt about the sustainability of mainland China's real estate boom:

In the past decade, the average sale price/sq.m of Chinese residential real estate has risen by 150%. Almost every metric (household debt/GDP ratios; years of median earnings to afford housing; median number of owned homes) points to the Chinese real estate boom being an order

of magnitude larger than the US 2008 housing crisis, and ready to pop at any moment. Our view is that the market is indeed significantly overvalued, due in large part to various government decisions (tax incentives to buy real estate; lack of trust in Chinese equities, and a closed capital account). However, in the absence of an safe alternative for investment inside Chinese borders, our view is that the market will continue to crescendo in line with increasing Chinese consumer wealth. The biggest catalyst that could pop this bubble is the government opening capital accounts, which will be discussed in more detail in the next section. There is also the threat that Chinese equities could become more acceptable in the eyes of investors, however this would likely require years of work and a ground-up reinvention of Chinese financial regulators and laws.

Long term uncertainty over the future of Hong Kong as a gateway between China and the world, due to the geopolitical tensions between China and the US:

The past 4 years have seen massively ramped tension between China and the US, who see their global hegemony being threatened, and with HK in particular, over Chinas handling of the pro-democracy protests. Regardless of the results of the US presidential election, the animosity and de-coupling seems likely to continue. This has justifiably led to pessimism over the future of Hong Kong, which has served as a gateway between China and the West for centuries. However, we believe the pessimism is overblown. China still remains the factory of the world, and any de-coupling will likely take decades – decades in which Hong Kong will remain a critical junction for capital flow between East and West. The only exception is if China opens their capital accounts.

China's capital account is currently closed. This means that individuals are limited to moving USD$50,000 in any year, while corporate investments require governmental approval. Hong Kong handles the vast majority of capital flows between China and the rest of the world, a remnant of its colonial past that party officials have embraced. It is undeniable that Hong Kong's current position as a premiere Asian city for the financial, legal and many other sectors is founded upon this closed capital account. If the capital account was opened, there would likely be an exodus of companies to either Shanghai, which is closer to the heart of China, or Singapore, which is further away – instead of the now-awkward, red-headed stepchild of Hong Kong stuck in limbo. Without its role as intermediary, Hong Kong is little more than a small Chinese city with a rather unique past – it might not even be considered a tier 1 city. It goes without saying that this would absolutely devastate the profits of HKL's investment properties, with a mass exodus of tenants driving down rents and the loosened restrictions on luxury imports that come with capital accounts loosening vaporising demand for retail.

Meanwhile, as we saw in the previous section, developmental properties in the mainland would also be destroyed upon the loosening of capital accounts. This is because the supply of housing is currently far above what is actually required, and real estate simply functions as a means of investment for wealthy Chinese to park their new-found wealth. With no realistic alternatives that

have a history of safe, increasing prices, there is no choice but for this bubble to continue. Obviously, as soon as capital accounts are opened and Chinese investors gain easy access to alternative investments, prices will collapse to a realistic level, destroying house values.

Our opinion is that this doomsday scenario will eventually happen, but not for a very long time. China views the adoption of the RMB as the reserve currency of the world as a long-term goal, and the internationlisation and liberalisation of capital accounts is an unavoidable step to achieve this goal In 2014, China announced that they were gingerly beginning the road to capital account liberalisation, while keeping their fixed (undervalued) exchange rate which has worked so well for them. As could be expected, this attempt to have their cake and eat it didn't work too well. Outflows immediately skyrocketed, while the hoped-for investment inflows never materialised. China's foreign currency reserves plummeted, and it was obvious that the government would have to make a choice between liberalisation of capital accounts and the preservation of the exchange rate. In the end, the fixed exchange rate won, and currency restrictions were hastily re-imposed in 2017. Since then, there has been little further talk of capital accounts loosening. With this disastrous attempt in recent memory, we find it unlikely that China will decide to have 'Round 2' anytime soon, or at least until they find their fixed exchange rate to be redundant.

Catalysts

As our thesis is centered around the market overreacting to various negative catalysts, the most likely positive catalyst would be the non-realisation of various factors suppressing the market price.

In the short term, we would hope that continued positive rental revisions, increasing rental collections and the stability brought to Hong Kong by the national security law (which will hopefully be used sparingly to protect the appearance of Hong Kong governmental independence) will cause prices to rise to a more reasonable level.

Over the longer term, if China continues to have success, and continues to treat Hong Kong as it currently does (developing the Pearl River Delta economic region; using Hong Kong as an interchange between East and West, etc.), HKL's price should also rise even if US-China animosity continues, as the situation settles into a new Cold War, rather than the current state of uncertainty and constant escalation. There is a significant chance that as HKL continues to develop investment properties outside of Hong Kong, with both the West Bund site in Shanghai and various other properties in SEA, that they will be repriced as a proxy for luxury office/retail in the high-growth Asian market, rather than as a proxy for luxury office/retail in the mature Hong Kong market, increasing multiples.

Valuation

We created two valuation models, one as a conservative downside scenario where price realisation doesn't happen and HKL acts as a fixed-income bond proxy, and one where multiples change to accurately reflect reality. For the first model, we used a basic DDM with the following inputs: $0.22 annual dividend, and a WACC of 4%. With dividend growth into perpetuity of the following conservative inputs, we find the following valuations.

Dividend growth		
Base	0%	$ 5.50
Bear	-2%	$ 3.67
Bull	2%	$ 11.00

In the second valuation model, we created a DCF where each operating segment (development and investment) models out various capitalisation rates and book values over time. We accounted for the short-term impact of Covid through writing down book values for a set number of years. We used a custom discount rate of 7%, as a weighted average of exposure to the safer investment properties and more risky development properties. We did not model the possible changes to discount rate as a result of changing proportions between investment and development properties. With that framework and the following assumptions, we have the following scenarios:

DCF Intrinsic value			
	Low yield	**Average yield**	**High yield**
High writedown	$ 3.77	$ 5.05	$ 5.76
Low writedown	$ 5.57	$ 7.21	$ 8.14
No writedown	$ 6.36	$ 8.13	$ 9.16

Assumptions:

Writedowns are permanent and incurred in a lump sum at the beginning on 2020.

In the high writedown scenario, we write down investment properties by 25% and development properties by 50%. In the low writedown scenario, we write down investment properties by 5% and development properties by 25%. In the no writedown scenario, there are no writedowns.

Operating yields are based on 1 standard deviations above and 2 below historical averages.

In the low yield scenario, investment properties yield 2.3% and development properties yield 6%. In the average yield scenario, investment properties yield 2.8% and development properties yield 7%. In the high yield scenario, investment properties yield 3% and development properties yield 8%.