FIRST SHANGHAI GROUP 第一上海

Hang Lung Properties 恒隆地产 (101)

Company Update

Buy

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A New Canary Wharf in West Kowloon

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➢ **West Kowloon is hotter.** The tenants will move to ICC in Kowloon Station soon. We believe that this will stimulate the demand of residential units in West Kowloon and Tai Kwok Tsui Areas. Furthermore, The Cullinan of SHKP is going to launch in 2H08. We think that this will trigger a property boom in West Kowloon area. In addition, the recent launched The Palazzo in Shatin and Celestial Heights in Ho Man Tin received a warm response from the market, which would drive up demand of deluxe residential units in HK.

➢ **Revise our ASP assumption.** We revise our average selling price (ASP) assumption for Hang Lung Properties (HLP) properties for sales in HK. We remain our assumption unchanged for the projects sold in FY 08. However, we revise ASP for The HarbourSide in Kowloon Station by 7% and 12% upwards to HK$20k per sq ft in FY 09 and HK$ 23k per sq ft. Meanwhile, assumption of ASP for The Long Beach in Tai Kwok Tsui is adjusted upwards by 1% to HK$7,400 per sq ft in FY 09 and by 3% to HK$ 8,300 per sq ft.

➢ **China is star.** Currently, HLP owns two investment properties in Shanghai with close to 100% occupy rate. Annual rental income from the projects in China is estimated to soar to HK$ 1,704m in FY 10 from HK$ 931m in FY 07. Furthermore, five projects in Shenyan, Jinan, Tianjin and Wuxi are under construction or planning. If all projects are completed, total leasing area in China will surge to 1.8m sqm in 2013 from 0.3m sqm now. So, the strong income growth in China will become HLP mid and long-term engine.

➢ **Revise earning and target price upward.** Following to our revision of ASP assumption, we lift our earning forecast by 2.5% to HK$ 11,205m in FY 09 and 4.7% to HK$ 12,260m in FY 10. Furthermore, our target price is also revised to HK$ 33.6 to reflect our latest FY 09 NAV forecast of HK$ 37.35 per share and represents a 10% discount to GAV. Upside potential is 25.6%. Recommendation is upgraded to **BUY.**

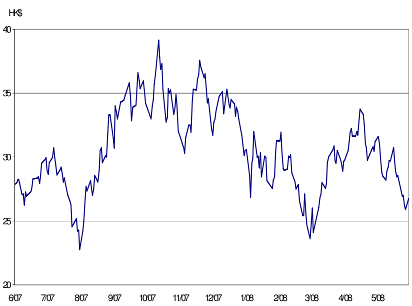
Industry	HK Properties
Price	HK$26.75
Target price	HK$33.60 (+25.6%)
Stock code	101
Market cap.	HKD110,882mn
O/S shares	4,145mn
52wk high/low	HK$39.35 / 21.80
NAV per share	HK$37.35
Major shareholder	Hang Lung Group Limited (51.0%) JP Morgan (5.8%)

Earning Summary

Year-end 30 June	FY06A	FY07A	FY08E	FY09E	FY10E
Turnover (HKD m)	3,657	4,389	11,096	12,517	14,343
Growth (%)	-47	20	153	13	15
Net Profit (HKD m)	4,403	6,371	10,327	11,205	12,260
Growth (%)	-35	45	62	9	9
EPS (HKD)	1.19	1.59	2.49	2.70	2.96
Growth (%)	-38.4	34.2	56.5	8.5	9.4
PER (x)	22.7	16.9	10.8	10.0	9.1
DPS (HKD)	0.51	0.56	0.75	0.81	0.89
Yield (%)	1.9	2.1	2.8	3.0	3.3

Source: Company information, FSSL

Price Performance



Source: Bloomberg

Western Kowloon is changing

New CBD above Kowloon Station

Community above Kowloon Station becomes mature & completion of ICC will enhance property demand

Kowloon Station has been operated for more than 10 years. The recent completed shopping mall, Element, attracts many people visiting Kowloon Station. We think that the community above Kowloon Station becomes more mature. Furthermore, 118-storey of International Commerce Centre (ICC) in Kowloon Station is going to complete in 2H08. Pre-lease process is smooth and about 80% of 2.5 m sq ft grade A office at ICC has been leased. Several investment banks, such as Morgan Stanley, Credit Suisse and Deutsche Bank, will move to ICC. We believe that demand for residences is to increase around Kowloon Station when the tenants move in ICC.

Figure 1: Union Square above Kowloon Station

1 – The Waterfront
2 – Sorrento
3 – The Arch
4 – HarbourSide
5 – Elements
6 – The Cullinan
7 - ICC

Source: Union Square

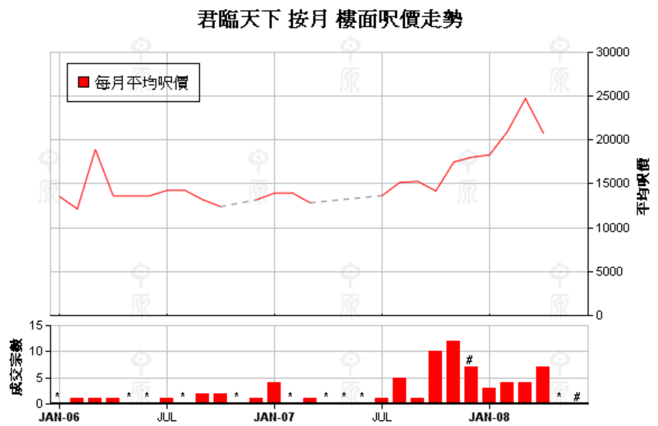
Named as Union Square

Several property developers including USI Holdings, Wharf, Hang Lung Properties (HLP) and Sun Hung Kai Properties joined with MTR Corporation to develop a 12 m sq ft integrated property development above Kowloon Station that is named as Union Square. Being completed in 2009, Union Square will comprise luxury apartments, serviced apartments, two hotels, shopping mall and office space.

The Cullinan is expected to sell at HK$18k/sft

In Kowloon Station, residential units include The Waterfront, Sorrento, The Arch, HarbourSide and The Cullinan. All units in The Waterfront and Sorrento were sold out a few years ago. In addition, majority of The Arch and about 25% of Harbourfront are sold out. The Cullinan is a new project and is expected to launch in 2H08. Thus, residences available for sales in Kowloon Station are limited. We think the price of residential units in Kowloon Station will still trend upwards although it consolidates recently. Currently, selling price of The Waterfront, Sorrento, The Arch, HarbourSide are HK$ 10,273 per sq ft, HK$ 11,492 per sq ft, HK$ 15,666 per sq ft and HK$ 19,498 per sq ft respectively. It is estimated that selling price of The Cullinan will reach HK$17,000-18,000 per sq ft. when it goes to market in 2H08.

Figure 2: Price of The HarbourSide



Source: Centaline

Figure 3: Price of Sorrento

Source: Centaline

Figure 4: Price of The Arch

Source: Centaline

Figure 5: Price of The Waterfront

Source: Centaline

Booming of Primary Luxury Units

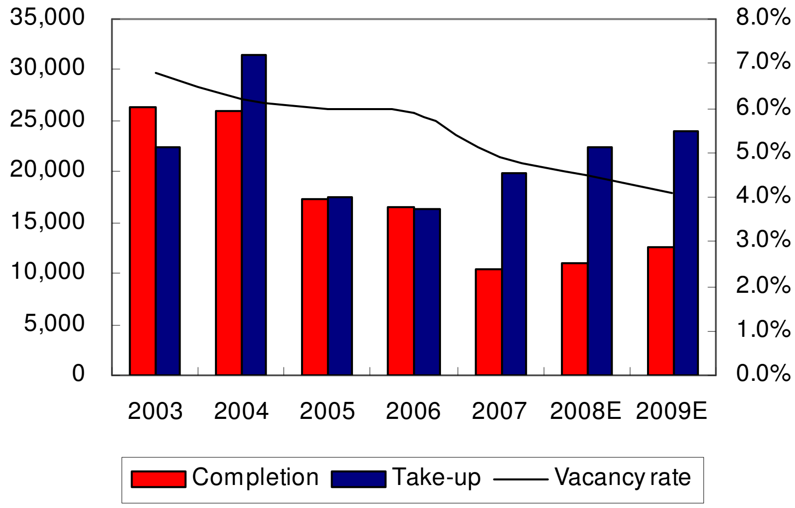
The Palazzo and Celestial Heights have good sales results

In May, 2008, two luxury residential projects are launched in Hong Kong. Namely, The Palazzo in Shatin and Celestial Heights in Ho Man Tin. Sino Land, developer of The Palazzo, had sold 1000 units at an average price of HK$9,000 per sq ft since the release on May 9, 2008. On the other hand, 210 units of Celestial Heights at an average price of HK$13,800 per sq ft were sold in two days after its launch on May 22, 2008. The strong primary sales results drove the recovery of secondary market. It is reported that weekend sales at “10 blue-chip estates” soared from 30-40 deals to 50-60 deals over the past two weekends. Furthermore, the last unit of Severn 8 on the Peak was sold out with the average price of HK$55,987 per sq ft that set a price record for residential property in Asia.

Many factors enhance market sentiment

We think that the recent booming atmosphere in the primary market would trigger another round of up cycle. First of all, mortgage interest rate is as low as 2.4% per annum. Although we expect there may be rate hike by the end-08, its effect is insignificant due to extremely low mortgage rate, which is far below inflation rate. Secondly, high inflation is expected to be sustainable in coming year as the food price and oil price still stay at plateau. Generally speaking, property price benefits from inflation. At last, the supply of newly built housing is limited. Based on Rating and Valuation Department, residential completion is expected to be 10,980 units in 2008 and increase to 12,679 units in 2009. However, they are far below the average completion of about 26,000 units in 2003 and 2004. Thus, the limited supply of newly completed residential would support property price in HK next few years.

Figure 6: Private Domestic Completions, Take-up and Vacancy in HK



Source: Rating and Valuation Department

Revise ASP upwards

Price in The HarbourSide soars

Revise ASP of The HarbourSide & The Long Beach

In order to reflect the latest market situation and our bullish viewpoint of residential market in Western Kowloon, we revise our assumption on the average selling price (ASP) of HLP's projects in HK, especially those in West Kowloon. Since financial year of Hang Lung ends at June, we maintain our assumption unchanged for FY08. However, we adjust upwards ASP assumption for The HarbourSide by 7% to HK$20,000 per sq ft in FY09 and 12% to HK$23,000 per sq ft in FY10. Meanwhile, we lift our ASP assumption for The Long Beach by 1% to HK$7,400 per sq ft in FY09 and 3% to HK$8,300 per sq ft in FY10.

Table 1: Average Selling Price Assumption

(HK$/ sq ft)	FY 08		FY 09		FY 10	
Project	Old	New	Old	New	Old	New
The HarbourSide	17,000	17,000	18,700	20,000	20,570	23,000
Aqua Marine	5,200	5,200	5,720	5,720	6,292	6,400
Carmel-on-the-Hill	5,300	5,300	5,830	5,800	6,413	6,400
The Long Beach	6,667	6,667	7,334	7,400	8,067	8,300
% Change						
The HarbourSide		0%		7%		12%
Aqua Marine		0%		0%		2%
Carmel-on-the-Hill		0%		-1%		0%
The Long Beach		0%		1%		3%

Source: FSSL

So Much Unsold Units

More than 2,000 unsold units

We have mentioned before that annual housing supply is estimated to be around 11,000-13,000 units in 2008-09. HLP revealed that the company had 2,042 unsold and completed residential units on hand by end-07 that represented about 16-19% of annual supply. So we think that HLP can benefit from our HK booming property market. In fact, the company does not have a clear picture for disposal of unsold stocks. Selling plan depends on the market sentiment and company's financial planning.

Table 2: Unsold inventory left on HK Properties

Type	No. of unsold units	% of project
The Long Beach	1,224	67%
The HarbourSide	767	68%
AquaMarine	38	2%
Others	13	7%
Total:	2,042	

Source: Company information

China is the Second Story

Duplicate Shanghai story in different cities of China

Closed to 100% occupy rate in Shanghai IP

The successful story of Plaza 66 and The Grand Gateway in Shanghai encourages HLP exploring China market. The huge demand of prime office and shopping mall in Shanghai makes the occupy rate of Plaza 66 and The Grand Gateway close to 100%. In order words, the stable rental income would support HLP business development in China. Now, the company enters into 5 development projects in Shenyang, Jinan, Tianjin and Wuxi and wishes these projects to become cash cow in future.

Projects start to construct in China

The construction of Shenyang Zhongjie Hang Lung Plaza, Phase 1 of Shenyang City Hang Lung Plaza, Jinan Hang Lung Plaza and Tianjin Hang Lung Plaza commenced in Oct 2006, Apr 2007, Dec 2007 and May 2008 respectively. The first completion will start in 2009 and all development will finish in 2013. After completion, land bank in China will increase by 1.5m sqm to 1.8m sqm.

Table 3: Project Development of HLP in China

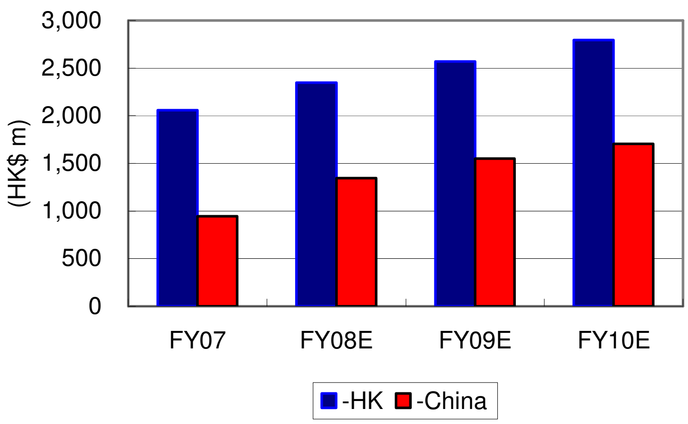
Project	Interest (%)	Total GFA (sqm)	Usage	Total Investment (RMB Bn)	Completion Date
Shenyang Zhongjie Hang Lung Plaza	100	109,700	Retail	2.5	2009
Jinan Hang Lung Plaza	100	150,000	Retail	2.5	2010
Tianjin Hang Lung Plaza	100	153,000	Retail	3.2	2011
Shenyang City Hang Lung Plaza	100	800,000	Integrating	8.0	2012
Wuxi Hang Lung Plaza	100	255,000	Commercial	3.5	2013
	Total	1,467,700		19.7	

Source: Company information

Robust rental income growth from China properties

In FY 07, total rental income amounted to HK$3,004m, of which rental from China investment properties was HK$931m or represented about 31% of total. We estimate that rental income contributed from Chinese operation would increase from HK$ 931m in FY 07 to HK$ 1,704m in FY 10 that represents a CAGR of 22.3% in FY 2007-10. The growth rate of rental income from China is in faster pace than that from Hong Kong. We believe that it would accelerate beyond 2010 after more projects in China complete.

Figure 7: Rental Income by Geographical Classification



Source: Company Information, FSSL

Financial Analysis

Adjust FY 09-10E Profit upwards

Lift forecast by 3% in FY09 and 5% in FY10

Following to the adjustment of our ASP assumption, we review our financial model. Since majority of the properties for sales in FY 08 have been sold, we maintain our earning forecast unchanged in FY08 as HK$10,327m. We lift our earnings forecast by 2.5% to HK$ 11,205m in FY09 and by 4.7% to HK$ 12,260m in FY10.

Given to our assumption on gain in revaluation of investment properties of HK$ 5 bn each year in FY 08-10, underlying profit is estimated to be HK$ 6,202m, HK$ 7,105m and HK$ 8,210m in the corresponding period respectively.

Table 4: Earning Revision

	Net Profit (HK$ m)		Change	EPS (HK$)		Change
	Old	New	(%)	Old	New	(%)
FY 08E	10,327	10,327	0.0%	2.49	2.49	0.0%
FY 09E	10,934	11,205	2.5%	2.64	2.70	2.4%
FY 10E	11,710	12,260	4.7%	2.83	2.96	4.5%

Source: FSSL

Low gearing secures power to expand

Net cash position in FY 08

As China continues tightening its monetary policy with Required Reserve Ratio (RRR) surging to 17.5%, bank borrowing is hard to obtain in China. Because of the prudence financial policy, HLP is financial sound enough to have any land acquisition in future. We estimate that HLP is in net cash position with HK$ 9,150m cash on hand by end-FY 08. Furthermore, the company will continue to sell off its inventories in HK for the expansion in China. Revenue from property sales is expected to surge from HK$ 1,386m in FY 07 to HK$ 7,405m in FY 08, and then to HK$ 8,398m in FY 09 and HK$ 9,844m in FY10.

Valuation

NAV in FY 09 is HK$37.35 per share

After we revise our ASP forecast, FY 09 NAV is adjusted upwards to HK$37.35 per share from HK$ 36.54 per share. Since financial position of HLP is sound, we apply a discount rate of 10% to gross asset value for our target price calculation. Our target price is HK$ 33.6 per share, representing a 25.6% upside potential. Recommendation is upgraded to BUY.

Table 5: NAV estimation

	(HKD m)	NAV per share	% NAV	Remark
Property sales	55,597	13.41	35.9%	DCF with WACC 11.75%
Property under development	27,303	6.59	17.6%	
Property leasing	72,200	17.42	46.6%	
- Hong Kong	57,555	13.89	37.2%	
- China	14,645	3.53	9.5%	
Gross Amount	155,099	37.42	100.2%	
Less: Net debt	(297)	(0)	-0.2%	
NAV	154,802	37.35	100.0%	At FY 09
No. of shares	4,145			
NAV per share	37.35			

Source: FSSL

Risks

High Inflation. China's Consumer Price Index rose to 7.7% in May 2008, following to 8.5% in April and 8.3% in March. Meanwhile, earthquake in Sichuan may push up the price of cement and steel elsewhere in China. Thus, construction cost in China may surge in the future.

Interest Rate Risk. PRC's inflation may initiate an interest rate increment. Any increase in bank borrowing rate will increase HLP' interest expense on the outstanding debt. On the other hand, Federal Reserve in the US may raise the rate in 2H08 in order to fight against inflation.

Austerity Measures. If Chinese Government introduces stricter measures to cube with the property market, the Company may face difficulty on land acquisition or fund raising activities and hence a delay in project completion.

Global Economy Slowdown. Oil price hits new high. This may result in the global economy slowdown. Demand of offices in HK and China will decrease and rental income of HLP will be hurt.

Financial Summary

Income statement Year end June 30 (HK$ m)	2006	2007	2008E	2009E	2010E
Turnover	**3,657**	**4,389**	**11,096**	**12,517**	**14,343**
-Property leasing	2,595	3,004	3,691	4,119	4,499
-Property sales	1,062	1,386	7,405	8,398	9,844
COGS	(1,305)	(1,686)	(2,965)	(3,007)	(3,150)
Gross profit	**2,352**	**2,703**	**8,130**	**9,509**	**11,193**
Other revenue	317	303	463	447	474
SGA	(206)	(243)	(610)	(688)	(789)
Operating profit	**2,464**	**2,763**	**7,983**	**9,268**	**10,878**
Properties revaluation	3,438	5,962	5,000	5,000	5,000
Interest expenses	(416)	(297)	(208)	(336)	(435)
Jointly controlled entities	90	78	110	130	150
Pre-tax profit	**5,577**	**8,506**	**12,886**	**14,061**	**15,593**
Tax	(1,003)	(1,403)	(2,255)	(2,531)	(2,963)
After-tax profit	**4,574**	**7,103**	**10,631**	**11,530**	**12,631**
Minority interest	(171)	(732)	(303)	(325)	(371)
Net profit	**4,403**	**6,371**	**10,327**	**11,205**	**12,260**
Underlying profit	**1,627**	**2,048**	**6,202**	**7,105**	**8,210**
EPS (HK$)	**1.19**	**1.59**	**2.49**	**2.70**	**2.96**
DPS (HK$)	**0.51**	**0.56**	**0.75**	**0.81**	**0.89**

Key statistics and ratios Year end June 30	2006	2007	2008E	2009E	2010E
Growth (%)					
Turnover	-47	20	153	13	15
Operating profit	-28	12	189	16	17
Net Profit	-35	45	62	9	9
Margins (%)					
Gross profit	64	62	73	76	78
Operating profit	67	63	72	74	76
Net Profit	120	145	93	90	85
Others (%)					
Effective tax rate	18	16	18	18	19
Current ratio (X)	6.0	5.7	4.2	4.2	4.7
Payout ratio	43	35	30	30	30
ROE	10	13	17	16	16
ROA	8	11	15	14	14
Valuation					
P/Sales (x)	27.3	24.6	10.1	8.9	7.8
PE (x)	22.7	16.9	10.8	10.0	9.1
P/B (x)	2.3	2.0	1.8	1.6	1.4
P/Cash flow (x)	54.1	37.2	17.6	19.9	24.3
Dividend yield (%)	1.9	2.1	2.8	3.0	3.3

Balance sheet Year end June 30 (HK$ m)	2006	2007	2008E	2009E	2010E
Cash & deposits	5,984	6,994	9,150	10,703	10,366
Trade debtors	1,097	837	2,642	2,980	3,415
Inventories	10,159	9,542	7,652	8,632	11,952
Fixed assets	42,501	51,204	60,199	69,193	77,186
Jointly controlled entities	551	597	643	689	853
Loans and investment	8	7	6	7	7
Deferred taxation	67	64	47	50	60
Total assets	**60,366**	**69,244**	**80,339**	**92,254**	**103,839**
Short term bank loan	0	0	0	0	0
Trade creditors	1,530	1,635	1,632	1,841	2,049
Taxation	332	190	800	900	1,250
LT Bank loans	8,454	4,782	6,954	9,500	12,000
Floating rate notes	1,500	1,500	1,500	1,500	0
Deferred taxation	3,691	4,813	5,743	6,476	7,300
Other LT liabilities	571	487	442	600	850
Total liabilities	**16,077**	**13,407**	**17,070**	**20,816**	**23,449**
S'holders' funds	**43,246**	**54,277**	**61,509**	**69,353**	**77,935**
Minorities	1,043	1,561	1,760	2,085	2,456
Total	**44,289**	**55,838**	**63,269**	**71,438**	**80,390**
Net gearing	**9.0%**	**Net cash**	**Net cash**	**0.4%**	**2.0%**
BVPS (HK$)	**11.9**	**13.5**	**15.3**	**17.2**	**19.4**

Cash flow statement Year end June 30 (HK$ m)	2006	2007	2008E	2009E	2010E
EBIT	2,232	2,504	7,685	8,906	10,509
Depreciation	4	4	5	6	7
Change in wc	28	764	81	(1,109)	(3,547)
Taxation	(470)	(421)	(1,644)	(2,431)	(2,613)
Others	53	129	162	204	200
CF from Operation	**1,846**	**2,980**	**6,289**	**5,575**	**4,557**
Capex	(1,219)	(2,549)	(4,000)	(4,000)	(3,000)
Associated investments	(6)	5	5	5	5
Others	266	364	520	749	866
CF from Investing	**(959)**	**(2,180)**	**(3,475)**	**(3,246)**	**(2,129)**
Equity raised	39	6,554	0	0	0
Change of Debts	3,889	(4,100)	2,172	2,546	1,000
Dividend paid	(1,878)	(1,957)	(2,403)	(3,098)	(3,362)
Others	(158)	(287)	(426)	(142)	(316)
CF from Financing	**1,891**	**210**	**(657)**	**(694)**	**(2,678)**
Change in Cash	**2,778**	**1,010**	**2,157**	**1,636**	**(249)**
FX Change	0	0	0	0	0
Cash at the beginning	2,506	5,284	6,294	8,450	10,086
Cash at the end	5,284	6,294	8,450	10,086	9,837
Adj: OD or others	700	700	700	617	529
Cash at BS	5,984	6,994	9,150	10,703	10,366

Source: Company information, FSSL

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