Hong Kong Property Sector

Research Analysts
Cusson Leung, CFA
852 2101 6621
cusson.leung@credit-suisse.com
Joyce Kwock
852 2101 7496
joyce.kwock@credit-suisse.com
Raymond Cheng, CFA
852 2101 6945
raymond.cheng@credit-suisse.com
Ronney Cheung
852 2101 7472
ronney.cheung@credit-suisse.com

SECTOR REVIEW

From dusk to dawn

- **With the sharp rebound in stocks since December, we believe it is not time to chase the entire sector now. There is still about 20% downside for the property market in 1H09. Stock prices tend to lead the physical market by about four months and we believe the best time to revisit the whole sector will be toward the end of 1Q09. In the meantime, the sector is likely to be range bound on news flow. The upcoming launches of the Cullinan and Lake Silver by SHKP and Sino Land/MTRC, respectively, are expected to be key sector catalysts.**
- **By assessing a checklist of seven factors (loan-to-deposit ratio, corporate gearing, mortgage rate, income growth, wealth impact, housing supply and demographic changes), we conclude that the property market is considerably stronger now than during the last down cycle – as highlighted below, the lower the score of each factor, the better. The key differentiating factors are the low level of leverage in the system and limited supply for the next few years.**
- **Office rents are staying firm for the time being, but we expect more downside in 2009 when vacancy rates could start to climb. For retail rents, we would not be surprised to see mass and prime shopping mall rents fall by 20% and 15%, respectively, in 2009 as private consumption shrinks.**
- **We continue to stick with the sector leaders. Our top picks among the developers are Cheung Kong and Sun Hung Kai Properties. Among the landlords, Great Eagle has limited rental reversion pressure in 2009, while Wharf and Swire also remain top picks because of their decentralised office and prime shopping mall exposure.**

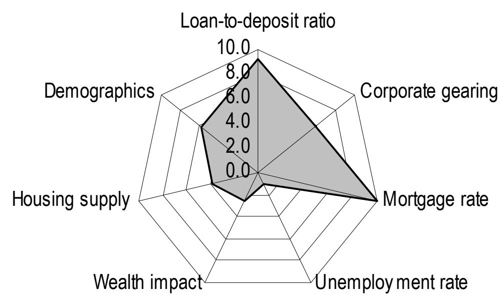
Scores – property market health (1 = best, 10 = worst)

	2008 peak	2003 trough	1998 trough	1997 peak
Loan-to-deposit ratio	3.3	3.5	7.0	9.3
Corporate gearing	3.0	8.0	8.0	6.0
Mortgage rate	2.0	1.0	10.0	10.0
Unemployment rate	2.9	8.4	6.1	1.1
Wealth impact	5.0	9.0	8.0	2.6
Housing supply	1.0	6.8	5.3	3.8
Demographics	7.1	8.4	6.8	5.9
Total	**24.2**	**45.1**	**51.2**	**38.7**

Source: CEIC, Credit Suisse

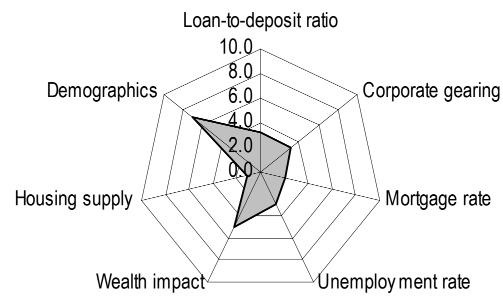
Focus charts

Figure 1: **Property market – peak 1997 (1 = best, 10 = worst)**



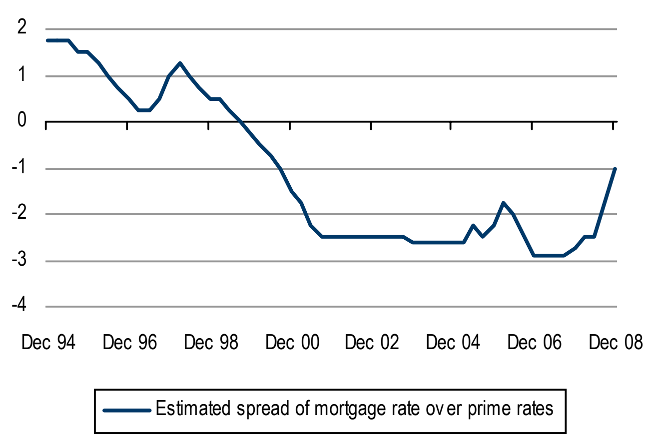
Source: CEIC, Credit Suisse estimates

Figure 2: **Property market – peak 2008 (1 = best, 10 = worst)**



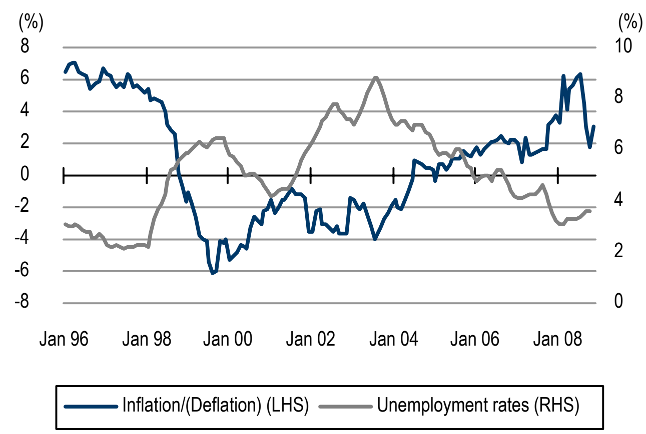
Source CEIC, Credit Suisse estimates

Figure 3: **Mortgage rate discount to continue to narrow**



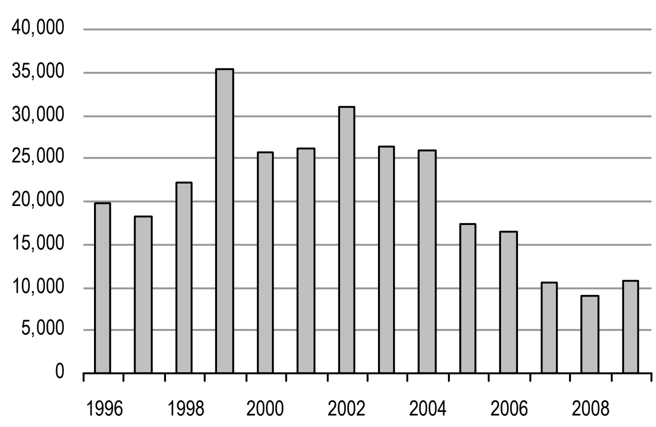
Source: CEIC, Credit Suisse estimates

Figure 4: **Deflation drove sharp jump in unemployment**



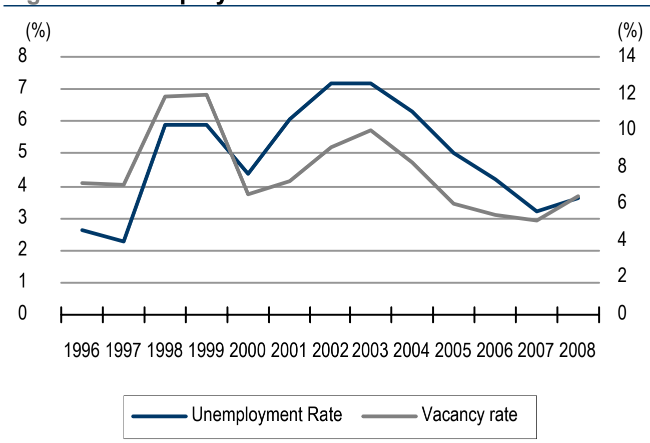
Source: CEIC, Credit Suisse estimates

Figure 5: **Limited supply in 2008E and 2009E**



Source: CEIC, Credit Suisse estimates

Figure 6: **Unemployment drove office vacancies**



Source: CEIC, Credit Suisse estimates

From dusk to dawn

Cheap but not distressed anymore

From their recent trough discounts of 51% and 53% for the developers and investors, respectively, property stocks have rebounded on average by about 34-41%. With the sector currently trading at 32% and 39% discounts to NAV for the developers and investors, respectively, valuations remain cheap but not distressed anymore. While we are still expecting 20% further downside in the residential market, mostly concentrating in 1H09, and given the sector tends to lead the physical market by about four months, we believe the best time to start considering bottom fishing is only at the end of 1Q09.

Stocks rebound from their recent trough discounts of over 50% to 32-39%

In the meantime, we would continue to stick with the sector leaders. Our top picks among the developers are Cheung Kong and Sun Hung Kai Properties. Among the landlords, due to the potential negative take-up in the market, we expect more downside for the office market, especially in Central in 2009, despite rents remaining firm for the time being. However, in terms of earnings volatility, the landlords should still be cushioned by the rental reversion cycle. Great Eagle should have limited reversion pressure in 2009. Wharf and Swire also remain top picks because of their decentralised office and prime shopping mall exposure.

Picking the leaders in the sector

Dissimilarity to the last bust

We were expecting property prices to fall by 41% from the peak in 2008. Given that prices have already fallen by 23%, we believe the remaining downside for the property market is about 20%. We have gone through a checklist of seven key parameters – loan-to-deposit ratio, corporate gearing, mortgage rate, income growth, wealth impact, housing supply and demographic changes. We conclude that on a scale of 1 to 10 (from best to worst), in all key aspects except for income growth, the Hong Kong current property market is much more sound than during the last peak in 1997. The main attributing factors supporting the property market are the lowered overall leverage of the economy, i.e., loan-to-deposit ratio and corporate gearing, stronger income growth, higher wealth effect from the stock market and much lower housing supply. While the higher wealth effect from the previous run in the stock and property markets is dissipating, lower overall leverage and the limited supply of housing over the next two to three years are not likely to change, thus, providing strong support to the property market.

Lower overall leverage in Hong Kong and substantially less residential supply are the main positive drivers for Hong Kong property

Office downside in 2009

Despite the resilience of Central office rents so far, we expect them to decline by about 35% in 2009. Based on the 3Q08 headline effective rent of HK$115/sq ft, as reported by Jones Lang LaSalle, and assuming rents remained flat in 4Q08, we expect the level to drop to about HK$75/sq ft. This assumes that the financial industry will continue to contract in 2009. There is certainly upside risk to this. For example, if China's economy were to revive in 2H09 and the prospects for the equity market improve, a potential increase in the IPO pipeline could rejuvenate demand for office space from the financial services sector.

Expecting 35% downside for Central office rents in 2009

Retail rents under pressure

We would not be surprised to see retail rents at mass and prime shopping malls fall by 20% and 15%, respectively, in 2009. Our view of a slightly smaller fall in retail rent for the prime shopping malls is based on: 1) increasing polarisation between prime and non-prime shopping malls during a downturn and 2) support from mainland tourist spending in Hong Kong on the potential opening up of more geographical coverage from the expansion of China's individual visitor scheme.

Potential changes to the China's individual visitor scheme could give the retail sector a boost

Sector valuation

Figure 7: **Valuation summary**

Company	RIC	Rating	Price (HK$)	TP (HK$)	+/- (%)	Mkt cap (HK$bn)	Curr. NAV (HK$/sh)	Disc. (%)	P/E (x) FY08	P/E (x) FY09	Yield (%) FY08	P/B (x) FY07
Cheung Kong	0001.HK	O	72.4	91.6	27	167.7	83.4	-13	9.4	9.6	3.5	0.7
Henderson Land	0012.HK	N	28.7	30.2	5	55.7	50.4	-43	11.2	24.1	3.8	0.6
Sino Land	0083.HK	N	8.1	7.7	-4	37.1	11.9	-32	14.7	11.6	5.0	0.8
SHKP	0016.HK	O	65.6	84.1	28	163.3	93.4	-30	15.7	20.7	3.8	0.9
Kerry	0683.HK	O	20.3	24.0	18	28.9	34.4	-41	9.7	13.8	4.7	0.7
MTRC	0066.HK	O	17.9	24.9	39	100.4	27.0	-34	11.3	16.6	2.4	1.1
Great Eagle	0041.HK	O	8.7	19.9	129	5.2	30.7	-72	5.4	5.9	38.4	0.2
Hang Lung Prop	0101.HK	N	16.7	19.1	14	69.4	23.8	-30	13.5	31.8	3.9	1.1
Hong Kong Land	HKLD.SI	U	2.5	2.1	-16	5.7	2.6	-5	13.7	10.3	6.1	0.6
Hysan	0014.HK	N	12.4	13.8	12	13.1	21.3	-42	10.8	10.7	5.0	0.4
Swire	0019.HK	O	53.1	75.9	43	48.6	94.9	-44	12.0	12.1	5.0	0.6
Wharf	0019.HK	O	21.0	28.1	34	57.8	37.5	-44	11.3	10.1	4.1	0.6

Source: Company data, Credit Suisse estimates

Figure 8: **Summary of EPS estimate changes**

Name	RIC	New EPS (HK$) FY08E	New EPS (HK$) FY09E	New EPS (HK$) FY10E	Old EPS (HK$) FY08E	Old EPS (HK$) FY09E	Old EPS (HK$) FY10E
Developers							
Cheung Kong	0001.HK	7.7	7.5	9.3	8.7	7.9	9.7
Henderson Land	0012.HK	2.6	1.2	1.3	2.8	1.5	1.6
Sino Land	0083.HK	0.547	0.7	0.2	0.5	1.3	0.6
SHKP	0016.HK	4.2	3.2	5.9	4.2	3.1	5.0
Kerry	0683.HK	2.1	1.5	2.5	2.1	1.5	2.5
MTRC	0066.HK	1.6	1.1	1.1	1.6	1.1	1.1
Investors							
Great Eagle	0041.HK	1.6	1.5	1.6	1.6	1.5	1.6
Hang Lung Property	0101.HK	1.2	0.5	1.6	1.2	0.5	1.6
Hong Kong Land	HKLD.SI	0.2	0.2	0.2	0.2	0.3	0.2
Hysan	0014.HK	1.2	1.2	1.1	1.2	1.2	1.1
Swire	0019.HK	4.4	4.4	4.8	4.4	4.4	4.8
Wharf	0004.HK	1.9	2.1	2.3	1.9	2.1	2.3

Source: Credit Suisse estimates

Cheap but not distressed anymore

Hong Kong property stocks remain cheap compared with their historical average valuation at an average discount to NAV of 32% for the developers and 39% for the investors. However, except for Great Eagle, we would consider any of the stocks' valuations as distressed anymore. From the recent trough, the developers and investors have rebounded by an average of 41% and 34%, respectively, and the trough discounts were at 51% and 53%.

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Figure 9: **Summary of rating and target price changes**

Name	RIC	Price (HK$)	Beta	Rating New	Rating Old	NAV New	NAV Old	Target price New	Target price Old	Potential up/down (%)	Target discount (%)	Discount to NAV (%) Current	Avg	Peak	Trough
Cheung Kong	**0001.HK**	**72.4**	**1.20**	**O**	**O**	**83.4**	**77.0**	**91.6**	**91.3**	**27**	**10**	**-13**	**-12**	**17**	**-39**
Henderson Land	0012.HK	28.7	0.95	N	N	50.4	47.1	30.2	28.3	5	-40	-43	-16	38	-60
Sino Land	0083.HK	8.1	1.38	N	N	11.9	12.8	7.7	8.3	-4	-35	-32	-28	42	-77
SHKP	**0016.HK**	**65.6**	**1.09**	**O**	**O**	**93.4**	**93.4**	**84.1**	**84.1**	**28**	**-10**	**-30**	**-9**	**36**	**-49**
Kerry	0683.HK	20.3	1.42	N	N	34.4	34.4	24.0	24.0	18	-30	-41	-30	33	-81
MTRC	**0066.HK**	**17.9**	**0.62**	**O**	**O**	**27.0**	**27.0**	**24.9**	**24.9**	**39**	**-8**	**-34**	**-17**	**14**	**-56**
Average												**-32**	**-19**	**30**	**-60**
Great Eagle	**0041.HK**	**8.7**	**0.63**	**O**	**O**	**30.7**	**30.7**	**19.9**	**20.0**	**129**	**-35**	**-72**	**-39**	**15**	**-79**
Hang Lung Prop	0101.HK	16.7	1.46	N	N	23.8	23.9	19.1	19.1	14	-20	-30	-20	54	-59
Hong Kong Land	HKLD.SI	2.5	0.74	U	U	2.6	2.6	2.1	2.1	-16	-20	-5	-20	17	-53
Hysan	0014.HK	12.4	0.63	N	N	21.3	21.3	13.8	13.8	12	-35	-42	-33	9	-66
Swire	**0019.HK**	**53.1**	**0.68**	**O**	**O**	**94.9**	**94.9**	**75.9**	**75.9**	**43**	**-20**	**-44**	**-19**	**29**	**-67**
Wharf	**0004.HK**	**21.0**	**0.90**	**O**	**O**	**37.5**	**37.4**	**28.1**	**28.1**	**34**	**-25**	**-44**	**-30**	**19**	**-82**
Average												**-39**	**-27**	**24**	**-68**

Source: Company data, Credit Suisse estimates

The significant rebound in property stocks was driven largely by improved transaction volume in the primary market, with the launches of La Grove and Peak One by SHKP and City 18 by Henderson Land in December and that these stocks were at a distressed valuation level. We believe that property prices have not yet finished their adjustment cycle. The latest rebound in the shares has just brought them back to a more reasonable level.

Figure 10: **Price comparison – current versus 2008 peak versus 2008 trough**

Name	RIC	31/12/08 price (HK$)	2008 peak price (HK$)	2008 trough price (HK$)	Peak to trough changes (%)	Trough to current changes (%)	Peak to current changes (%)	2008 trough discount to NAV (%)
Cheung Kong	0001.HK	72.4	147	60	-59.2	20.7	-50.7	-28
Henderson Land	0012.HK	28.65	78.4	22.8	-70.9	25.7	-63.5	-55
Sino Land	0083.HK	8.07	29.35	5.02	-82.9	60.8	-72.5	-58
SHKP	0016.HK	65.6	172.8	50.7	-70.7	29.4	-62.0	-46
Kerry	0683.HK	20.3	64.85	11.8	-81.8	72.0	-68.7	-66
MTRC	0066.HK	17.86	34.9	13.1	-62.5	36.3	-48.8	-52
Average					**-71.3**	**40.8**	**-61.0**	**-50.6**
Great Eagle	0041.HK	8.7	24.673	6.79	-72.5	28.1	-64.7	-78
Hang Lung Prop	0101.HK	16.74	34.5	13.08	-62.1	28.0	-51.5	-45
Hong Kong Land	HKLD.SI	2.47	4.99	2.02	-59.5	22.3	-50.5	-22
Hysan	0014.HK	12.4	25.7	10.6	-58.8	17.0	-51.8	-50
Swire	0019.HK	53.1	111.8	41.15	-63.2	29.0	-52.5	-57
Wharf	0004.HK	21	46.9	11.9	-74.6	76.5	-55.2	-68
Average					**-65.1**	**33.5**	**-54.4**	**-53.4**

Source: Company data, Credit Suisse estimates

Stick with the leaders

Given that the physical property market prices are expected to fall 20% further in 1H09 and then stay flat (after the recent 33-41% rebound from their trough), we believe that stocks are likely to remain in a narrow trading range until the economy stabilises, likely towards the end of the year. In the meantime, we continue to recommend the more defensive names among both developers and investors.

Cheung Kong Holdings (0001.HK, HK$72.40, OUTPERFORM, TP HK$91.60)

Cheung Kong's property stub is not cheap; accumulate only for upside from Hutchison

At one point, Cheung Kong's stub discount to NAV had narrowed to about 5% with its rebound; it has now widened back to about 26%. At this level, it is not very attractive in relation to the sector average valuation of 32% and its own historical average of 35%. As a property stock, we believe it is fairly valued at the current level, despite its substantially locked-in earnings and its aggressive market strategy in clearing inventory. The key impetus for any valuation upside would be mainly from our positive view on Hutchison Whampoa (0013.HK, HK$38.85, OUTPERFORM, TP HK$69.20,) which we still expect to see 78% upside from the current level. Our target price of HK$91.6 for Cheung Kong is based on a 20% holding company discount to our target price for Hutchison and a 20% discount to CKH's property assets.

Sun Hung Kai Properties (0016.HK, HK$65.60, OUTPERFORM [V], TP HK$84.06)

Upcoming sale of the Cullinan likely the key catalyst

From its trough discount of 46% in 2008, SHKP is currently trading at a discount of 30%, which is in line with the sector average valuation. The company's successful launch of the La Grove and Peak One has been a key driver for the rebound in the property sector. SHKP is targeting to launch the Cullinan project in West Kowloon after Chinese New Year, while soft marketing of this project has already begun with indicative pricing of over HK$20,000/sq ft. We believe that sales progress and pricing of this project will drive the share up. On the other hand, the company's substantial investment property portfolio also provides a strong earnings base to cushion its earnings volatility. Our target price is based on a 10% discount to its estimated NAV of HK$93.4.

MTR Corporation (0066.HK, HK$17.86, OUTPERFORM, TP HK$24.87)

Given the increasing bargaining power of the company over the land supply, we expect its profit-sharing ratios with developers to stay high

This is a quasi-transportation and property stock. The transportation front of MTRC is considered defensive, in our view, as rail traffic tends to be less volatile in an economic downturn. The company's merger synergy with KCRC should continue to help cushion the rail business earnings as well. We expect the automatic fare adjustment to be effective from 1 July 2009. On the property development front, given the increasing bargaining power of the company over land supply, we expect its profit-sharing ratios with developers to stay high. We expect property development earnings contributions for 2008-09 to be from the Capitol and the Palazzo. Its earnings certainties from these are high as almost all the units have been sold. Our target price of HK$24.87 is based on a 20% discount to its property assets and on a par with its real-related assets, which imply a blended discount of 8%.

Great Eagle (0041.HK, HK$8.70, OUTPERFORM, TP HK$19.97)

Relatively less reversion pressure in 2009

Great Eagle is the cheapest property stock in our coverage universe. There is overall pressure on the holding company's hotel operations in Boston and London. We expect the contribution from the hotel division to fall by 21% in FY09 and to account for 32% of operating earnings. More importantly, we believe the key driver is the company's holding in C-REIT (2778.HK, HK$2.18, NOT RATED), the holder of Citibank Plaza and Langham Place. The current occupancy of Citibank Plaza is 98% with a passing rent of HK$85/sq ft versus its latest achieved rent of HK$120/sq ft. While we expect 35% downside in Central office rents in 2009, the building will have only 14% of leases up for renewal this year. In Langham Place, the offices are 99% occupied, with only 5.7% of leases up for renewal in 2009. This could help to avoid some pressure during the current market softness. For retail, the mall is close to 100% occupied and only 15% of leases are due for renewal in 2009. As the stock is currently trading at a 72% discount to NAV, we believe the stock is one of the best ways to play the defensiveness of these two investment properties. Our target price is based on a target discount of 35%.

Swire Pacific 'A' (0019.HK, HK$53.1, OUTPERFORM, TP HK$75.90)

Despite pressure from Cathay, Swire's property assets are trading at only 9x 2009E P/E

We have recently revised down our earnings forecasts for Swire by 3%, 21% and 14% for 2008-10E, respectively, as we cut our earnings estimates for Cathay on weaker traffic and yield assumptions, which are partially offset by lower fuel costs. Despite the substantial earnings cuts, Swire is trading at about 11x 2009E P/E. If we strip out Cathay, Swire is trading at just 9x 2009E P/E. In terms of valuation, Cathay is now only 7.7% of Swire's estimated NAV of HK$94.9. The impact of any potential weakness on Swire's valuation should be minimal. We believe the company's decentralised office portfolio at Island East and its prime shopping mall at Pacific Place are likely to provide a strong cushion in the current downturn. The company's consistently conservative approach in China property expansion also makes it stand out in the current market environment. Our target price of HK$75.9 is based on an average discount of 20% to its NAV of HK$94.9.

Wharf Holdings (0004.HK, HK$21.00, OUTPERFORM, TP HK$28.06)

The China land premium payment schedule has now been extended to over the next few years, removing a significant burden on its financial situation

Wharf has experienced one of the sharpest rebounds from its recent trough (+77%) among the property stocks, but we believe the company still has the most defensive qualities in terms of its exposure to prime shopping malls and decentralised office space in both Tsim Sha Tsui (TST) and Causeway Bay. The shopping malls at Harbour City and Times Squares recorded low single-digit YoY sales growth in October, which is not bad in the current environment. Office rents at the Gateway are standing firm at about HK$40/sq ft with 97% occupancy, while Times Squares' office rents are at HK$45/sq ft with 98% occupancy. Despite the overall pressure on office rents, similar to Island East, we believe the rental gap between TST and Central will provide a better cushion to the downside. The company originally was to pay about HK$11 bn on outstanding land premium for its China land bank in 2009. However, the payment schedule has now been extended to over the next few years, removing a significant burden on its financial situation. Our target price of HK$28.06 is based on a 25% discount to its NAV of HK$37.5.

Catalysts in 1H09

Large-scale projects to be launched after the Chinese New Year

While property prices are likely to decline further in the coming months on the back of a rising unemployment rate (as in December), we believe the market is likely to react to any large-scale launches in 1H09. We believe the most prominent drivers will be SHKP's upcoming launch of the Cullinan and Sino/MTRC's Lake Silver. While we had seen very good take-up of the primary launches in December, those projects were relatively smaller with lower price tags. With the continued worsening of the employment picture, we are doubtful whether these upcoming launches will do well without any substantial reduction in price expectation.

Figure 11: **Major primary launches in FY09 – mostly in the New Territories**

District	Project name/address	No. of units	Developer
Ma On Shan	Lake Silver	2,169	Sino / MTRC
West Kowloon (Tai Kok Tsui)	Long Beach Tower 1, 2, 7, 8, 9	1,104	Hang Lung
Yuen Long	Central Park Tower Phase 2	1,068	Cheung Kong
Kowloon Station	The Cullinan	825	SHKP / MTRC
Yuen Long	Ma Tin Road	672	New World
West Kowloon (Tai Kok Tsui)	Cherry Bay project	522	Nam Fung / URA
Hung Hom	Harbour Place Tower 3	350	New World / SHKP
West Kowloon (Tai Kok Tsui)	33 Lai Chi Kok Road	107	Henderson
Kennedy Town	The Sail at Victoria	95	HKLand
Total		**6,912**	

Source: HKET, Credit Suisse estimates

For the Cullinan, for example, we expect an average selling price of HK$16,000/sq ft. In the current soft marketing, SHKP still expects to fetch a price of over HK$20,000/sq ft. Although the market has probably factored a much lower price assumption into its earnings forecasts, it would be a negative catalyst for the stock if the company fails to achieve its target. To avoid this sort of disappointment, we believe Sino will also launch its Lake Silver project in phases in order to test the market.

SHKP is looking for over HK$20,000/sq ft for the Cullinan

In our view, the upcoming launches will be seen more as an excuse for the market to take profit rather than to continue chasing these stocks from current levels.

Time to bottom fish now?

After the 23% fall in overall residential prices from their peak in 2008, we expect prices to drop a further 20% in 2009. We also expect a continued rise in the unemployment rate and the increasing negative wealth impact to be the key drivers of the last leg down for the property market. However, we believe the adjustment process will be done largely in 1H09. Office rents in Central had yet to fall in 3Q08, but we believe that a more dramatic drop is likely to come in 1Q09. The slowdown in domestic consumption and tourist arrival growth is starting to impact the retail sector. Tenants' sales at key shopping malls started to slow in October 2008.

Projecting a 20% fall in residential prices, concentrated mainly in 1H09

Figure 12: **Summary of 2009 property market forecasts**

(%)	2H08E	09E	From 2H08 to 2009E	Actual 2008	Implied 2009E
Residential	**-10**	**-35**	**-41.5**	**-22 from 2H08**	**-19.5**
Office rents					
Core Central		-35		20.50	-35.0
Decentralised		-25		WC: +27.0	-25.0
				TST: +18.2	
				HKE: +17.8	
				KLE: +5.7	
Retail rents					
Non-prime		-20		10.00	-20.0
Prime		-15		9.63	-15.0

Source: Company data, Credit Suisse estimates

For the residential market, we believe its bottom is likely to be found towards the end of 2Q09 and then remain flat for the rest of the year. We expect the whole adjustment process to be much quicker than in the previous down cycle after the Asian financial crisis, as the overall leverage level in the economy is significantly less this time and the potential supply/demand imbalance should provide a strong cushion to the downside.

Stocks move as a sector

Property stocks in Hong Kong, despite their different asset mixes, tend to move in tandem as a sector. Based on the past three troughs in the property market, 1995, 1998 and 2003, property stocks tended to lead the physical property market by about 40, 8-9 and 15-16 weeks, respectively. Averaging the past three troughs, property stocks led the property market by about 20 weeks or five months. It is also interesting to note that there is not much difference in the lead time between stocks and the whole sector tends to move together when factoring in a rebound in property prices.

Averaging the last three troughs, property stocks led the property market by about 20 weeks or five months

Figure 13: **Stock performance leading the physical property prices (weeks)**

	1.HK	12.HK	83.HK	16.HK	683.HK	66.HK	41.HK	11.HK	14.HK	19.HK	4.HK
1995 trough	40	40	40	41	n.a.	n.a.	41	41	39	40	41
1998 trough	9	9	2	5	2	n.a.	8	8	8	5	9
2003 trough	15	16	16	16	16	16	15	15	16	15	15
Average	**21.3**	**21.7**	**19.3**	**20.7**	**9.0**	**16.0**	**21.3**	**21.3**	**21.0**	**20.0**	**21.7**

Source: Company data, Credit Suisse estimates

As we are expecting property prices to bottom out towards the end of 1H09, we believe that property stocks will probably start to bottom out in February. However, we expect property stocks to stay flat at least until 2H09, as property prices are not likely to see a major rebound until the economic outlook starts to brighten, likely towards the year-end.

Figure 14: Share price movement of Cheung Kong vs CCL

Source: Centadata, Bloomberg

Figure 15: Share price movement of Henderson vs CCL

Source: Centadata, Bloomberg

Figure 16: Share price movement of Sino versus CCL

Source: Centadata, Bloomberg

Figure 17: Share price movement of SHKP versus CCL

Source: Centadata, Bloomberg

Figure 18: Share price movement of Kerry versus CCL

Source: Centadata, Bloomberg

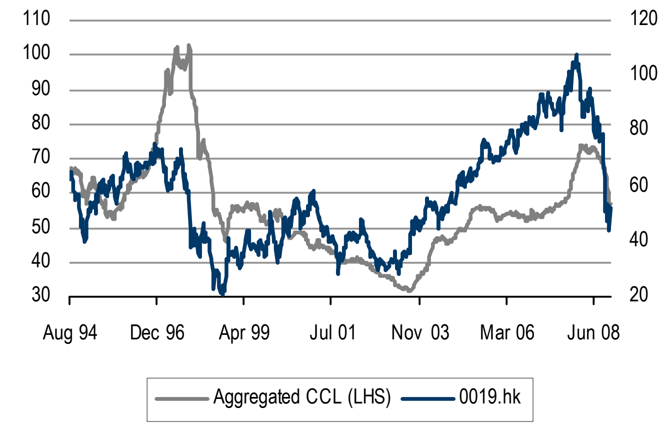
Figure 19: Share price movement of Wharf versus CCL

Source: Centadata, Bloomberg

Figure 20: Share price movement of Great Eagle vs CCL

Source: Centadata, Bloomberg

Figure 21: Share price movement of Swire versus CCL



Source: Centadata, Bloomberg

What has the valuation discounted?

Although property stocks are not trading at distressed levels anymore, after the recent rebound, their current share prices (assuming they are trading at their historical average discount to NAV) are pricing in a further 40% fall in residential prices and a 30-40% fall in office and retail rents. We believe the adjustment process of the property market has yet to be completed, but the magnitude of the correction will still be much lower than what current prices are implying. In the case of SHKP, if we assume an additional 30% reduction in property prices (on top of our current forecast of 20% downside), and office and retail rents, its NAV would be reduced to about HK$78 from HK$93.4. Based on its historical average discount of 9%, the stock should be fairly valued at HK$70.7 versus its current share price of HK$65.6. However, if one is bearish and applies its historical trough discount of 49%, this implies downside of 39% to HK$39.8. We believe this approach best gauges the bottom of its trading range if extreme market pessimism prevails, but it is not a good way to estimate its fair value given the double-counting impact of using trough discounts to trough NAV estimates.

Property stocks are now pricing in a 40% fall in residential prices and a 30-40% fall in office and retail rents

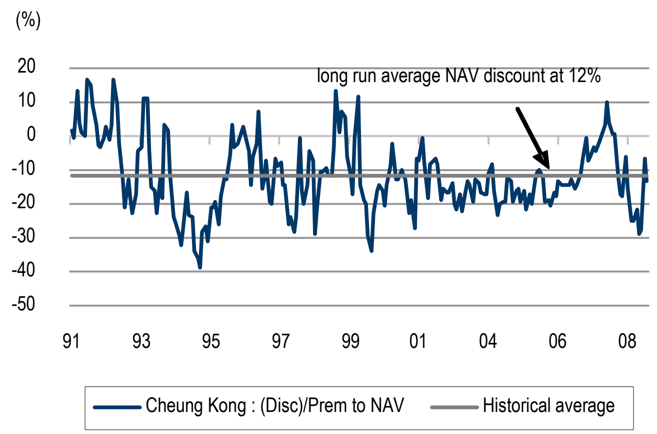
Figure 22: Sensitivity of NAVs to further price drop assumptions

				Further down in assumptions				Further down in assumptions			Further down in assumptions		
	RIC	Price (HK$)	NAV (HK$)	-10% NAV (HK$)	-20% NAV (HK$)	-30% NAV (HK$)	Avg. disc. (%)	-10% fair value (HK$)	-20% fair value (HK$)	-30% fair value (HK$)	-10% up/dn (%)	-20% up/dn (%)	-30% up/dn (%)
Cheung Kong	0001.HK	72.4	83.4	80.2	77.0	73.8	-12	70.7	67.8	65.0	-2.4	-6.3	-10.2
Henderson Land	0012.HK	28.7	50.4	46.9	43.4	39.9	-16	39.6	36.6	33.7	38.1	27.8	17.5
Sino Land	0083.HK	8.1	11.9	10.5	9.1	7.8	-28	7.5	6.5	5.6	-6.6	-18.9	-31.1
SHKP	0016.HK	65.6	93.4	88.3	83.1	78.0	-9	80.0	75.4	70.7	22.0	14.9	7.8
Kerry	0683.HK	20.3	34.4	33.2	32.0	30.8	-30	23.1	22.3	21.5	13.9	9.8	5.8
MTRC	0066.HK	17.9	27.0	25.9	24.7	23.5	-17	21.5	20.5	19.5	20.3	14.8	9.3
Great Eagle	0041.HK	8.7	30.7	30.4	30.1	29.8	-39	18.6	18.4	18.3	113.8	111.8	109.9
Hang Lung Prop	0101.HK	16.7	23.8	22.4	21.0	19.6	-20	17.9	16.7	15.6	6.8	0.0	-6.8
Hong Kong Land	HKLD.SI	2.5	2.6	2.2	1.8	1.3	-20	1.7	1.4	1.1	-29.3	-43.0	-56.7
Hysan	0014.HK	12.4	21.3	19.0	16.6	14.3	-33	12.7	11.2	9.6	2.4	-10.1	-22.6
Swire	0019.HK	53.1	94.9	88.9	82.8	76.8	-19	71.7	66.8	61.9	35.0	25.8	16.6
Wharf	0004.HK	21.0	37.5	33.9	30.3	26.7	-30	23.8	21.2	18.7	13.1	1.1	-10.9

Source: Company data, Credit Suisse estimates

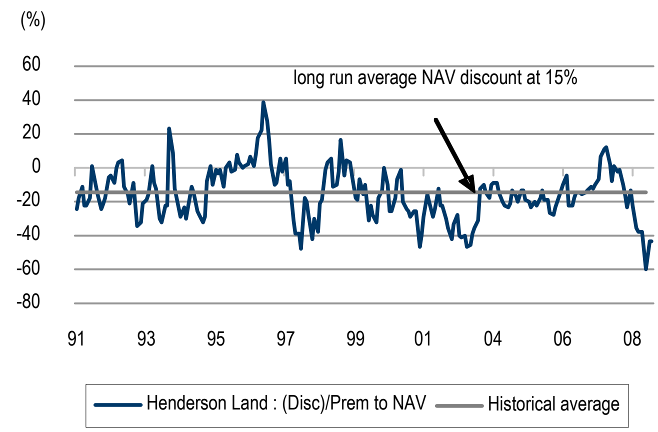
Discount to NAV

Figure 23: Cheung Kong's discount to NAV



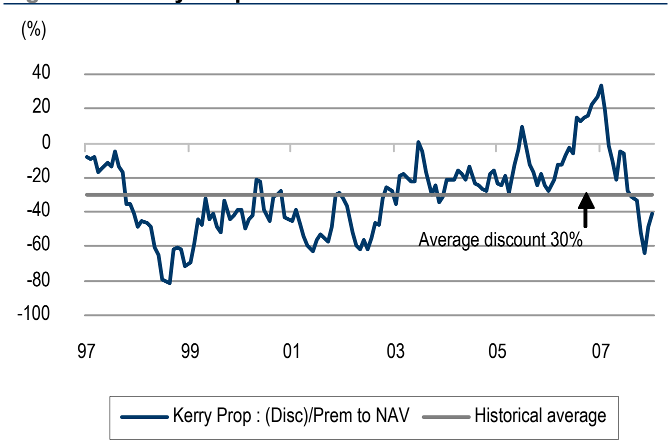
Source: Company data, Credit Suisse estimates

Figure 24: Henderson Land's discount to NAV



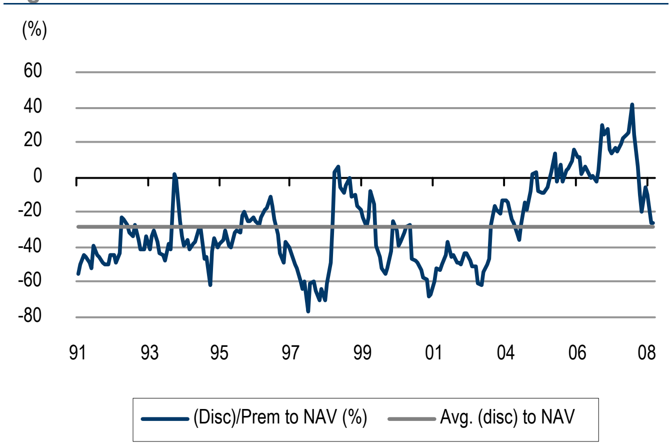
Source: Company data, Credit Suisse estimates

Figure 25: Kerry Properties' discount to NAV



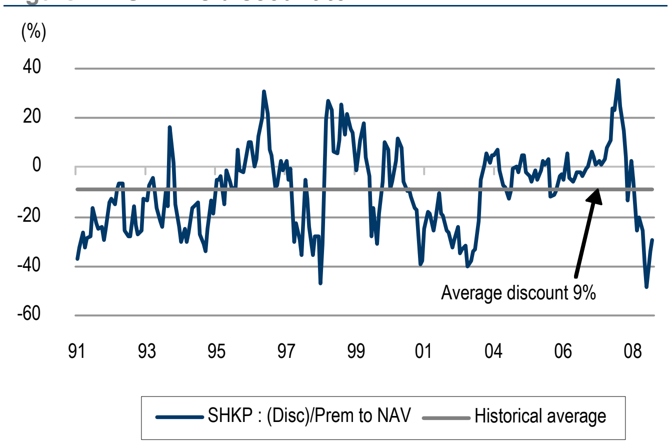
Source: Company data, Credit Suisse estimates

Figure 26: Sino Land's discount to NAV



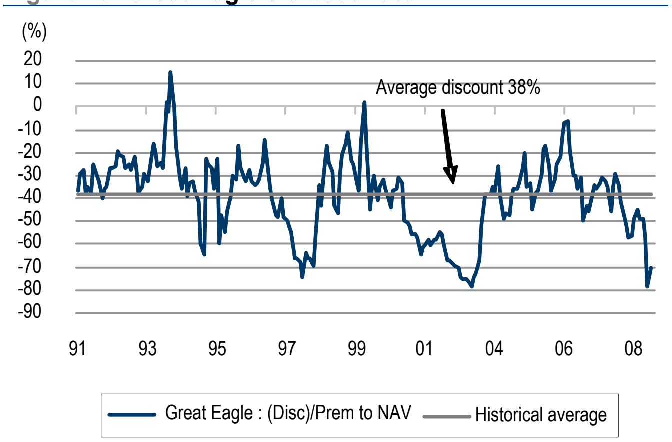
Source: Company data, Credit Suisse estimates

Figure 27: SHKP's discount to NAV



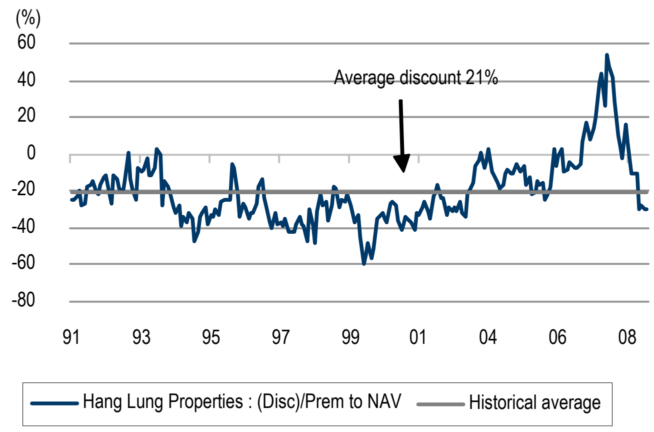
Source: Company data, Credit Suisse estimates

Figure 28: Great Eagle's discount to NAV



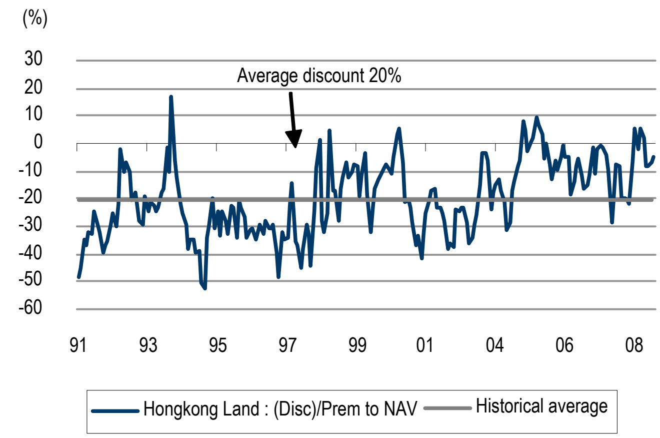
Source: Company data, Credit Suisse estimates

Figure 29: Hang Lung Properties' discount to NAV



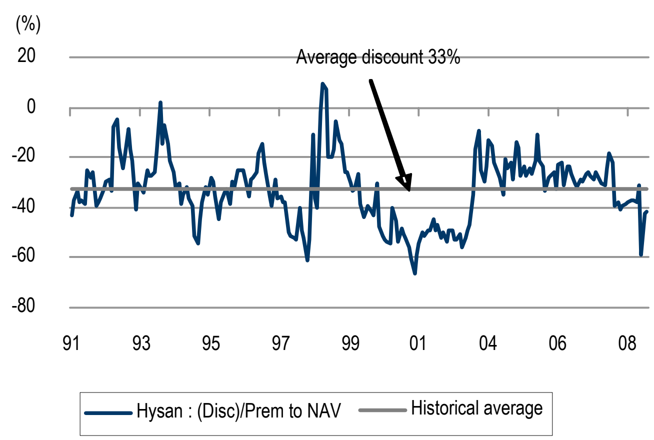
Source: Company data, Credit Suisse estimates

Figure 30: Hongkong Land's discount to NAV



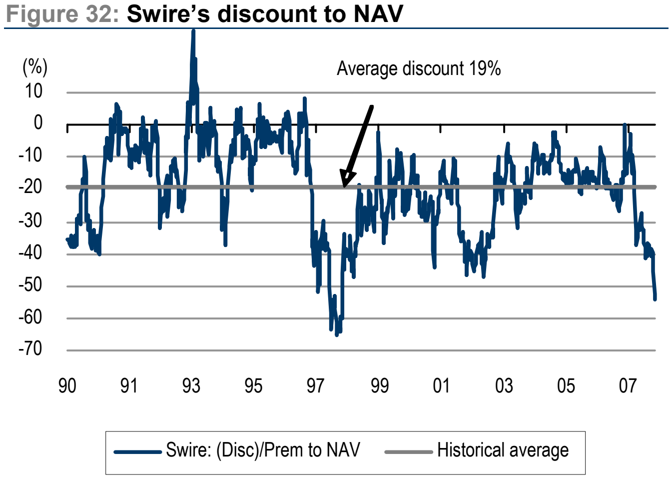
Source: Company data, Credit Suisse estimates

Figure 31: Hysan's discount to NAV



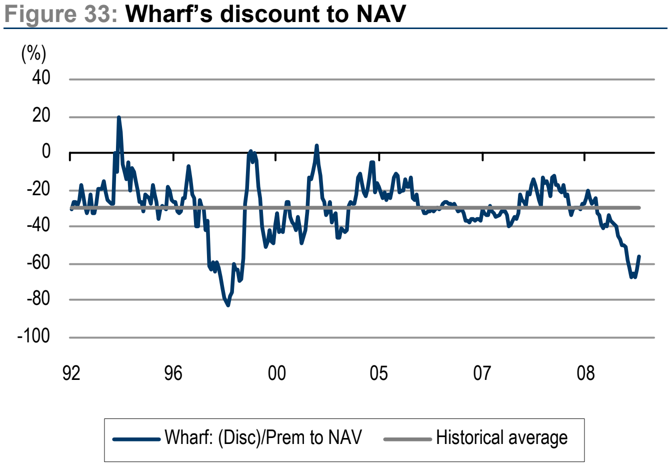
Source: Company data, Credit Suisse estimates

Figure 32: Swire's discount to NAV



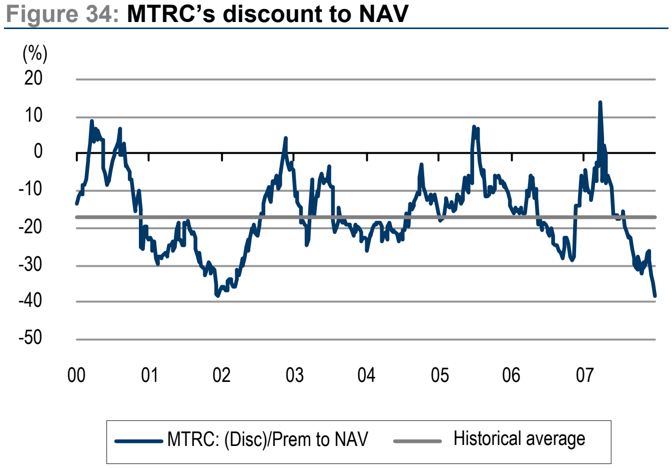
Source: Company data, Credit Suisse estimates

Figure 33: Wharf's discount to NAV



Source: Company data, Credit Suisse estimates

Figure 34: MTRC's discount to NAV



Source: Company data, Credit Suisse estimates

Dissimilarity to the last bust

Hong Kong property fundamentally sound

Despite the severity and state of the current global financial crisis, we believe the current health of the Hong Kong's property market is much stronger than during the Asian financial crisis in 1997-98. Property prices on average fell by about 65% from the peak in 1997 during the last crisis period and the entire deleveraging process took roughly six years, with the last leg of the downturn exacerbated by the SARS outbreak in 2003. Although property prices have more than doubled from the trough in 2003 to the peak in 2008, the average price level was still about 30% below the peak in 1997.

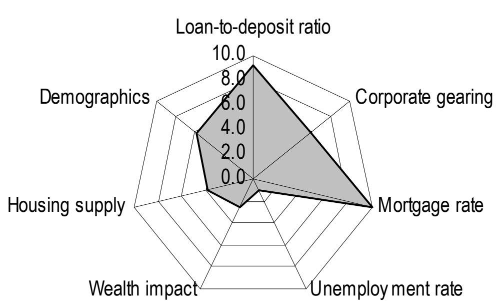
Despite the fact that property prices have more than doubled from the trough in 2003 to the peak in 2008, the average price level is still about 30% below the peak in 1997

Figure 35: Property Price Index movement since the last cycle

Source: CEIC, Credit Suisse estimates

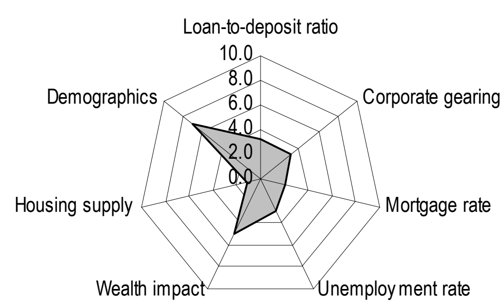
The fundamentals of the property market are also considered much healthier *now* than during the peak level in 1997. We have compiled a checklist of seven key parameters to access and compare the "health" of the property market with the last peak cycle. The factors underlying the property market that we examined are loan-to-deposit ratio, corporate gearing, mortgage rate, income growth, wealth impact, housing supply and demographic changes.

Figure 36: Peak Sept. 1997 (1 = best; 10 = worst)



Source: CEIC, Credit Suisse

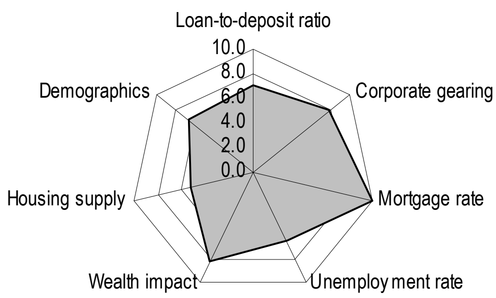
Figure 37: Peak June 2008 (1 = best; 10 = worst)



Source: CEIC, Credit Suisse

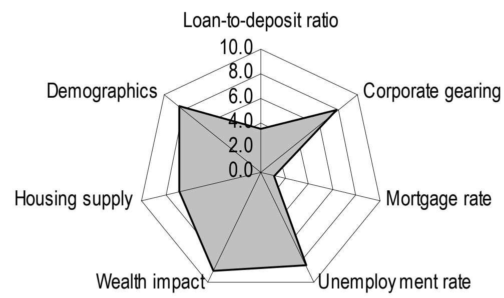
On a scale of 1 to 10 (1 being best and 10 worst), in all key aspects except for income growth, the Hong Kong property market even at the peak in 2008 was considered much healthier than what it was during the previous peak in 1997. The current state of the property *market* is also considered stronger than during its trough in 2003, even after a six-year asset deflation period.

Figure 38: Trough 1998 Dec. (1 = best; 10 = worst)



Source: CEIC, Credit Suisse

Figure 39: Trough 2003 Sept. (1 = best; 10 = worst)



Source: CEIC, Credit Suisse

The main attributing factors that support the property market are the lowered overall leverage of the economy, i.e., loan-to-deposit ratio and corporate gearing, stronger income growth, higher wealth effect from the stock market and a much lower housing supply. While the higher wealth effect from the previous run in the stock and property markets is dissipating, the overall lower leverage and limited supply of housing over the next two to three years are not likely to change, thus providing strong support for the property market. This is also one of the key reasons for our belief that a further fall in the property market will probably be confined to 20% in 2009, yet making it about 43% above its trough level in 2003.

The overall lower leverage and the limited supply of housing over the next two to three years are not likely to change thus providing a strong support to the property market

Figure 40: Scores – property market health (1 = best, 10 = worst)

	2008 peak (Jun 08)	03 trough (Sept 03)	98 trough (Dec 98)	97 peak (Sept 97)
Loan-to-deposit ratio	3.3	3.5	7.0	9.3
Corporate gearing	3.0	8.0	8.0	6.0
Mortgage rate	2.0	1.0	10.0	10.0
Unemployment rate	2.9	8.4	6.1	1.1
Wealth impact	5.0	9.0	8.0	2.6
Housing supply	1.0	6.8	5.3	3.8
Demographics	7.1	8.4	6.8	5.9
Total	**24.2**	**45.1**	**51.2**	**38.7**

Source: Company data, Credit Suisse estimates

Mortgage rates

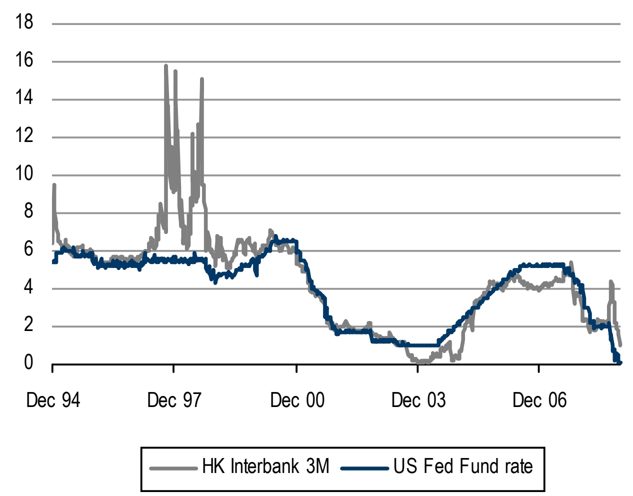
Although there is a risk of a further rise in mortgage rates, even in a worst-case scenario, we believe the absolute level would still be substantially lower than at the peak during the Asian financial crisis.

In the midst of the global financial crisis and with US target rates being set to almost zero, the Hong Kong 3M interbank rate has broken the 1% mark. This is the lowest level that we have seen since the trough in 2003. We believe that benchmark rates are unlikely to see any significant upward adjustment over the next 12 months, with the global economy struggling at its bottom. What is unusual this time, though, is that the Hong Kong prime rate and mortgage rates are not coming down in line with the fall in global benchmark rates and the local inter-bank rates. If we simply look at the Prime-HIBOR spread, it is now back up to about 400 bp at the end of the year from a squeezed level of less than 100 bp in October 2008. The improved interest rate spread theoretically should have provided sufficient leeway for banks to lower lending rates.

Figure 41: **Hong Kong mortgage rates**

Source: CEIC

Figure 42: **Hong Kong interbank versus US Fed rates**



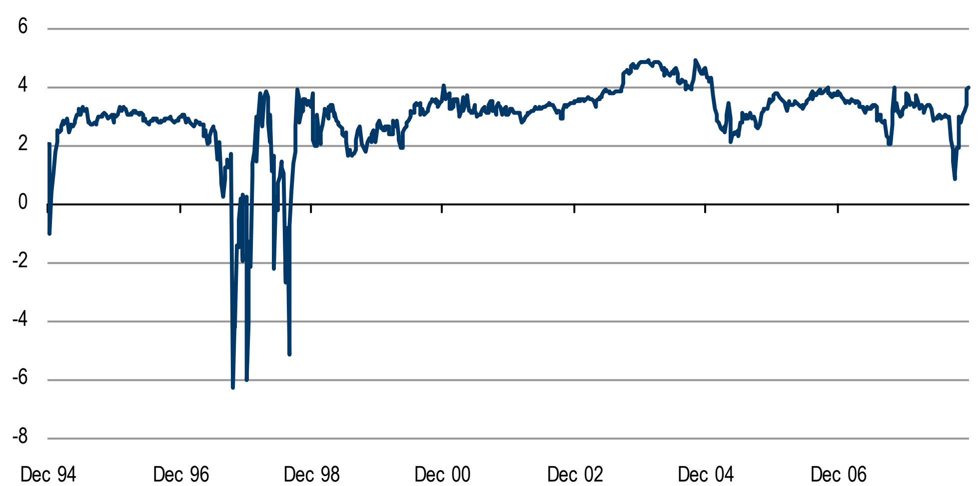
Source: CEIC

Weaker revenue growth and rising credit costs are reasons banks are not likely to lower mortgage rates

However, according our Hong Kong banks analyst, Chris Esson, there are two big challenges for local banks:

- *Weaker revenue*. The outlook for income generation is poor. Balance sheet growth is expected to be limited, margins should come under pressure as a result of heightened competition and non-interest income is likely to contract sharply given weak demand for wealth management products and declining consumer spending (hence credit card fee income).
- *Rising credit costs*. We expect credit costs to spike in 2009. Delinquency rates in corporate lending portfolios are forecast to rise sharply in early 2009, reflecting lower demand from developed markets. At the same time, we believe concern will grow over the outlook for consumer asset quality, given increased unemployment.

Figure 43: **Hong Kong Prime/HIBOR spread**



Source: Bloomberg

As a result, the improved interest rate spread serves only as a remedy to the overall decline in profitability for the banks and to compensate for the risk of anticipated rising credit costs.

Figure 44: **Latest mortgage rates in Hong Kong**

Bank	Mortgage rate (%)	Cash rebate (if any) (%)	Effective interest rate (%)
HSBC	P – 1 to 1.75	Max 0.5	2.5 – 4
Standard Chartered	P – 1.25 to 2	Max. 0.5	3.25 – 4
BOC Hong Kong	<HK$1.5m: P-1.25	<HK$1.5m: 0.2	3.5- 3.75
	>HK$1.5m: P-1.5	>HK$1.5m: 0.5	
Bank of East Asia	P-2	Max 0.5	3.25
Citi	P-2	0.30	3.25
ICBC (Asia)	P-1.75	Max. 0.3	3.50
Citic Ka Wah	P-2	--	3.25
Chong Hing	P-2.25	Max 0.5	3

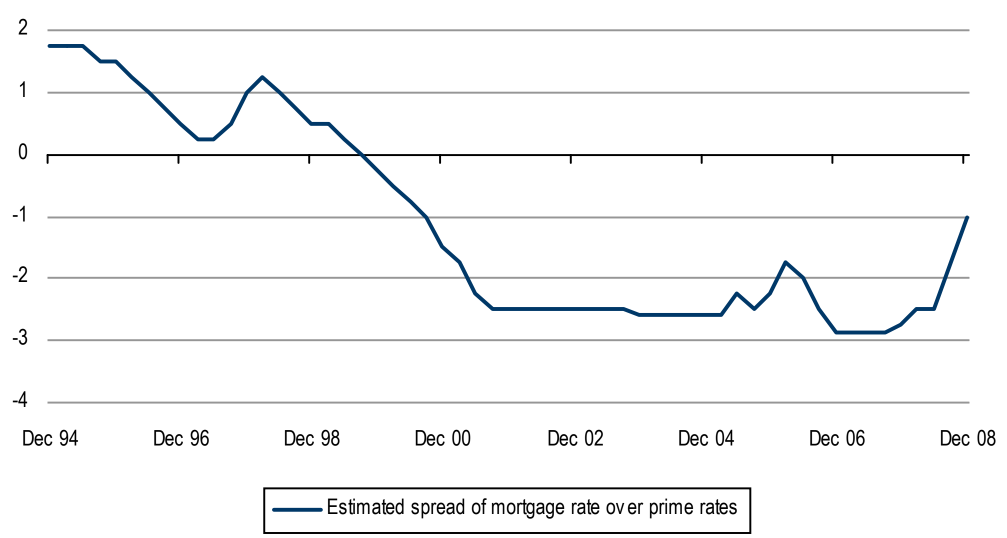
Source: HKET

Back to the prime-plus era

With the backdrop of a worsening profitability outlook for local banks, we believe there is a chance that Hong Kong mortgage rates could go back to the prime-plus era, as it was in before the late 1990s. While the prime rate is now being capped by the globally lowered benchmark rates, we believe the potential upside (the worse case) for mortgage rates would be about prime plus 175 bp. Using the prime rate of larger banks at 5%, this would indicate a worst-case mortgage rate of 6.75%. However, in absolute terms, this level would still be substantially lower than at the peak of 11.5% in 1998.

A worst-case for the mortgage rate is 6.75% if it goes back to prime +175 bp

Figure 45: **Mortgage rates moving towards prime level amid credit-tightening**



Source: CEIC

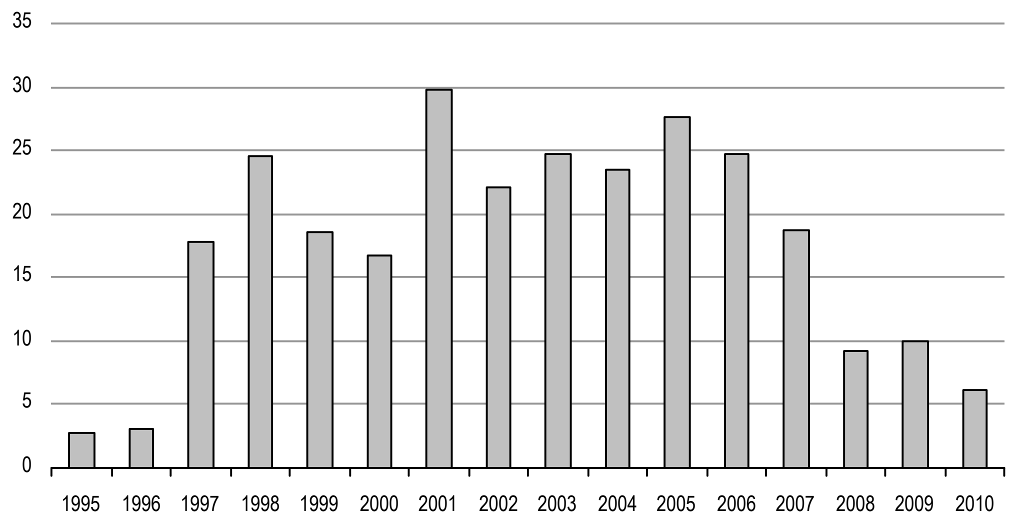
Corporate gearing

Substantially lower leverage on the corporate balance sheets nowadays is a major positive in terms of avoiding a massive de-leveraging process as witnessed during the aftermath of the Asian financial crisis. Based on the Credit Suisse Hong Kong coverage universe, corporate gearing was about 9.2% at the end of 2008 versus the average of 22% for the six-year de-leveraging period after 1997. In other words, assuming the same absolute level of net borrowing, the equity base of these corporates would need to be at least halved to achieve a similar level of gearing.

Having said that, there is huge de-leveraging pressure in both the global financial and real estate markets. To some extent, the Hong Kong property market is also affected by the de-leveraging process of foreign companies when they offload their real estate holdings in Hong Kong. In our view, the initial fall in property prices in Hong Kong was driven mainly by these types of foreign investors unwinding their positions and the process has pretty much been done. Under normal circumstances, the global de-leveraging process would have been much more damaging if not for the global bailout efforts and the massive liquidity injection into the system. We believe that Hong Kong's property market also has marginally benefited in this regard.

The initial fall in property prices in Hong Kong was driven mainly by foreign investors unwinding their positions and the process is pretty much done

Figure 46: **Corporate gearing (Credit Suisse Hong Kong universe)**



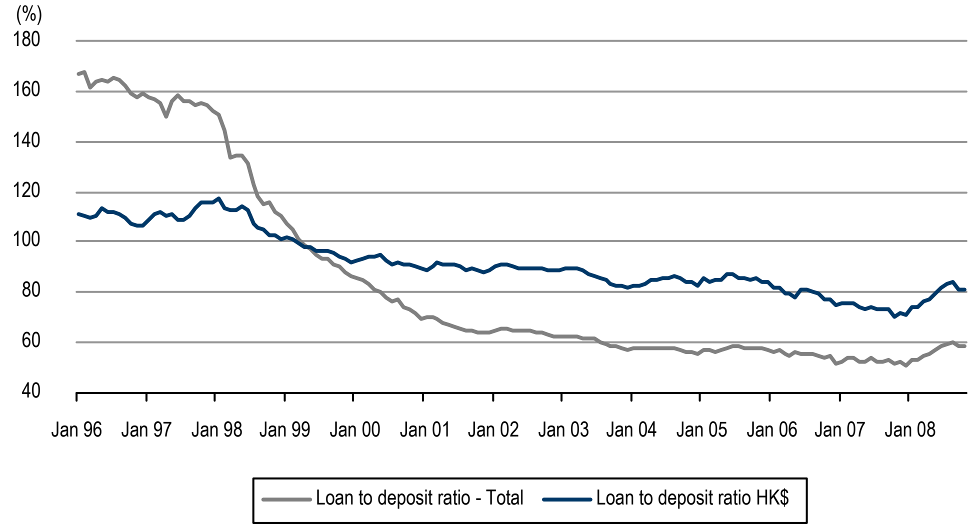
Source: Company data, Credit Suisse estimates

Loan-to-deposit ratios

Apart from the corporate gearing levels of the listed Hong Kong companies, we believe another key gauge of the system leverage is banks' loan-to-deposit (L/D) ratios, which, to some extent, indicate the banks' aggressiveness in using their balance sheets. During 1997-98, the peak aggregated L/D ratio in Hong Kong was 117%, and it continued to fall to the recent level of 81%. On the one hand, this measure shows up nicely in our overall "healthiness" score of the property market, given that the amount of leverage on banks' balance sheets is limited. On the other hand, it does show the unwillingness of banks to lend on: 1) the competitive pricing of the lending rates, especially in the mortgage market and 2) their increased reliance on non-interest income streams. With a better margin on lending and rising pressure on non-interest income in 2009, we expect the L/D ratio could go up again. If a rise in mortgage rates has been priced into property prices, we believe the potential increase in bank lending could be positive for property market transaction volumes.

With a better margin on lending and rising pressure on non-interest income in 2009, we do expect there will be a chance of the L/D ratio to go up again

Figure 47: **Leveraging has kept narrowing since the Asian financial crisis**



Source: CEIC, Credit Suisse estimates

Unemployment rate

The unemployment rate is one area that scores well for the property market now, but momentum is definitely worsening. Despite its recent rise to about 3.6%, we believe this is still well below its equilibrium level. According to our economics team, the worsening global financial market and subsequent negative wealth impact on domestic consumption is expected to push the unemployment rate up to about 6% in 2009 versus the peak level of 6.5% in November 1999. While the first wave of layoffs was concentrated in the financial services sector, which employs a total of 164,000 people, we believe that unemployment from the wholesale, retail, trade, restaurant and hotels sectors is likely to be the main driver pushing the rate up further. When the Asian financial crisis began in September 1997, it took 27 months for the unemployment rate to peak in November 1999. Assuming that it takes about the same time to reach the peak unemployment rate, this implies that 3,140 workers would be laid off every month in Hong Kong, on average, which is quite extreme, in our view.

We believe the unemployment rate from the wholesale, retail, trade, restaurant and hotels sectors is likely to be the main driver pushing unemployment higher

Figure 48: **Unemployment rate expected to climb up to 6% by FY09**

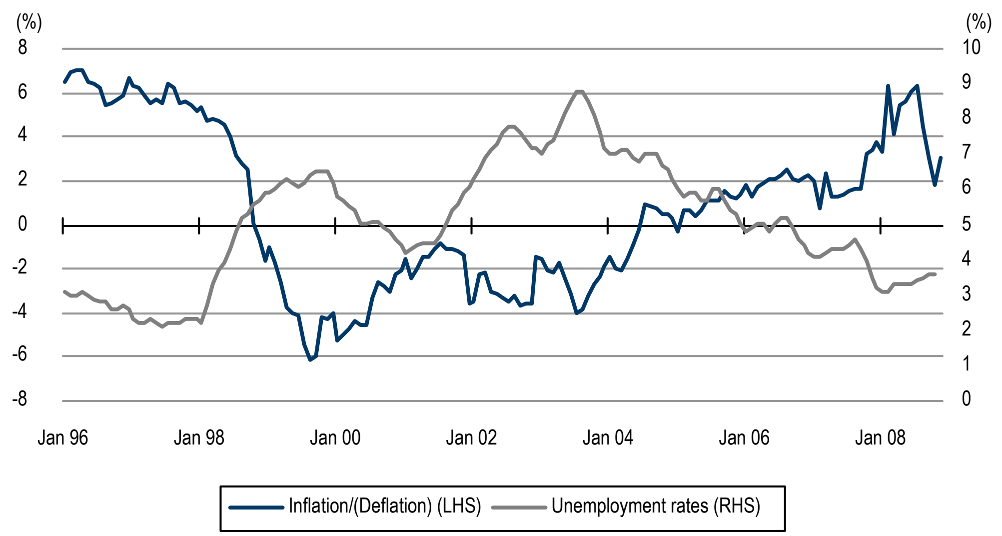
Source: CEIC, Company data, Credit Suisse estimates

Putting our economic team's view aside, we believe the big call is whether Hong Kong will return to a deflationary cycle, as witnessed during 1999-2003. The momentum of the Hong Kong CPI is definitely slowing down but the substantial deflationary cycle in Hong Kong was caused by a combination of an ultra high interest rate environment and substantial leverage in the system. None of these factors are prevailing in Hong Kong this time around. In our view, an internally induced prolonged deflationary cycle is quite unlikely to happen. With this in mind, we believe the chance of the local unemployment rate challenging its previous high is quite limited.

The big call is whether Hong Kong return to a deflationary cycle, as we witnessed during 1999-2003

With China being the growth engine of Hong Kong, the slowdown in its economy and the trading sector will have a direct negative impact on Hong Kong. However, we would not rule out China implementing policy measures that could help to cushion the downside risks to the economy. One example could be the expansion of geographical coverage for the individual visitor scheme from China, which could directly stimulate local tourism and the retail industry.

Figure 49: **Deflationary cycle caused a sharp jump in the unemployment rate**



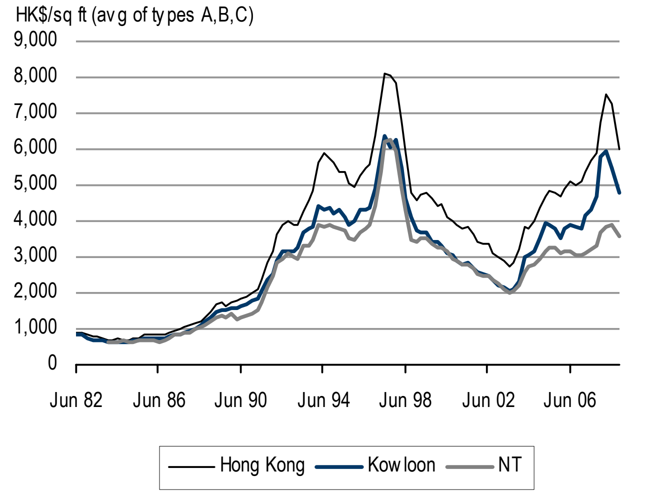
Source: CEIC, Credit Suisse estimates

How will the unemployment rate affect property prices?

The common belief is that so long as the affordability ratio stays at a low level, it will provide a strong support to property prices. We would argue that the affordability ratio will tend to contract when the unemployment rate starts to rise. As and when job security is in doubt, an average household will normally tend to allocate a smaller portion of income to mortgage payments for "safety" purposes. This relationship has generally held true for the past 15 years.

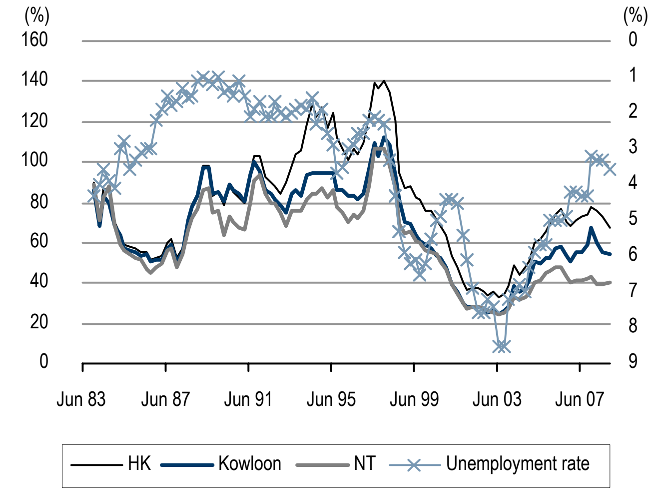
Based on our regression analysis between the Hong Kong unemployment rate and the affordability ratios for Hong Kong, Kowloon and the New Territories, we highlight the potential changes in the affordability ratios on the back of the potential increase in unemployment. The affordability ratios for Hong Kong, Kowloon and the New Territories are currently 68%, 54% and 40%, using the average price of type A, B and C for each of Hong Kong, Kowloon and the New Territories, as published by the government, and further assuming an average unit size of 500 sq ft, a mortgage rate of 4%, a mortgage term of 20 years and a loan-to-value ratio of 70%.

Figure 50: **Average residential property prices by district**



Source: CEIC

Figure 51: **Unemployment rates versus affordability ratios**



Source: CEIC, Credit Suisse estimates

If unemployment increases to 6%, according to the Credit Suisse economic team's projection, we believe the affordability ratios for Hong Kong, Kowloon and the New Territories will retreat to 51%, 38% and 34%, respectively. The market impacted most significantly would be Hong Kong Island property prices, where we would expect affordability to fall from 68% to 51%.

Figure 52: **Sensitivity of affordability ratios to unemployment rate**

	Unemployment rate (%)						
	3.0%	**3.5%**	**4.0%**	**4.5%**	**5.0%**	**5.5%**	**6.0%**
Hong Kong	74	70	66	63	59	55	51
Kowloon	63	59	54	50	46	42	38
New Territories	56	52	48	45	41	37	34

Source: CEIC, Credit Suisse estimates

According to our sensitivity analysis, assuming the mortgage rate stays at 4%, property prices in Hong Kong Island and Kowloon are expected to correct by a further 25% and 30%, respectively. This regression model could be a bit oversimplified but useful in showing the direction and the relative magnitude for changes in property prices.

Figure 53: **Sensitivity of property prices to changes in mortgage and unemployment rate**

	Unemployment rate (%)						
Hong Kong	**2.0%**	**3.0%**	**4.0%**	**4.5%**	**5.5%**	**6.0%**	**7.0%**
2.50	38	25	12	6	-7	-14	-27
2.75	35	22	10	3	-10	-16	-29
3.00	32	20	7	1	-12	-18	-30
3.25	29	17	5	-1	-14	-20	-32
3.50	26	14	2	-4	-15	-21	-33
3.75	23	12	0	-6	-17	-23	-35
4.00	21	9	-2	-8	-19	-25	-36
4.25	18	7	-4	-10	-21	-26	-37
4.50	16	5	-6	-12	-22	-28	-39
Kowloon							
2.50	51	33	15	6	-3	-20	-38
2.75	47	30	13	4	-5	-22	-40
3.00	44	27	10	2	-7	-24	-41
3.25	41	24	8	-1	-9	-26	-42
3.50	38	22	5	-3	-11	-27	-43
3.75	35	19	3	-5	-13	-29	-45
4.00	32	16	1	-7	-15	-30	-46
4.25	29	14	-1	-9	-17	-32	-47
4.50	26	11	-3	-11	-18	-33	-48
New Territories							
2.50	80	59	38	27	17	-4	-25
2.75	76	55	35	24	14	-6	-27
3.00	72	52	32	22	12	-8	-29
3.25	68	48	29	19	9	-10	-30
3.50	64	45	26	16	7	-12	-32
3.75	61	42	23	14	4	-14	-33
4.00	57	39	21	11	2	-16	-35
4.25	54	36	18	9	0	-18	-36
4.50	51	33	15	7	-2	-20	-37

Source: CEIC, Credit Suisse estimates

Figure 54: **October 2008 versus December 1999 – employment and unemployment distribution by industry**

	10/08			% of total		12/99			% of total	
	Employment	Unemployment	Unemployment rate (%)	Employment	Unemployment	Employment	Unemployment	Unemployment rate (%)	Employment	Unemployment
Manufacturing (Mfg)	192,400	7,700	4.0	5.4	6.8	355,600	27,000	7.6	11.4	14.9
Mfg: Food and beverage	21,800	1,700	7.8	0.6	1.5	20,300	1,500	7.4	0.6	0.8
Mfg: Clothing and footwear	34,800	2,500	7.2	1.0	2.2	104,900	10,700	10.2	3.4	5.9
Mfg: Paper and printing	49,800	1,000	2.0	1.4	0.9	59,100	2,900	4.9	1.9	1.6
Mfg: Other manufacturing industries	86,000	2,500	2.9	2.4	2.2	171,400	11,900	6.9	5.5	6.6
Construction	274,600	15,400	5.6	7.7	13.7	287,800	38,100	13.2	9.2	21.0
Construction: Foundation and superstructure	203,200	10,600	5.2	5.7	9.4	213,600	25,500	11.9	6.8	14.1
Construction: Decoration and maintenance	71,400	4,800	6.7	2.0	4.3	74,200	12,600	17.0	2.4	7.0
Wholesale, retail, trades, restaurants & hotels (WR)	1,149,700	48,600	4.2	32.4	43.1	946,600	65,900	7.0	30.2	36.4
WR: Wholesale and retail	342,600	17,800	5.2	9.7	15.8	315,300	24,600	7.8	10.1	13.6
WR: Import and export trades	543,100	15,000	2.8	15.3	13.3	392,700	15,100	3.8	12.5	8.3
WR: Restaurants and hotels	264,000	15,800	6.0	7.4	14.0	238,600	26,200	11.0	7.6	14.5
Transport, storage and communications (TS)	375,200	13,100	3.5	10.6	11.6	338,900	16,600	4.9	10.8	9.2
TS: Transport	319,300	11,100	3.5	9.0	9.8	283,100	14,200	5.0	9.0	7.8
TS: Storage	5,400	400	7.4	0.2	0.4	3,800	500	13.2	0.1	0.3
TS: Communications	50,500	1,600	3.2	1.4	1.4	52,000	1,900	3.7	1.7	1.0
Financing, insurance, real estate & business services (FI)	592,000	13,500	2.3	16.7	12.0	438,100	15,700	3.6	14.0	8.7
FI: Financing	164,000	3,000	1.8	4.6	2.7	124,400	3,800	3.1	4.0	2.1
FI: Insurance	40,000	600	1.5	1.1	0.5	43,200	1,000	2.3	1.4	0.6
FI: Real estate and business services	388,000	9,900	2.6	10.9	8.8	270,500	10,900	4.0	8.6	6.0
Community, social and personal services (CS)	941,000	13,800	1.5	26.5	12.2	735,400	16,800	2.3	23.5	9.3
CS: Public administration	112,800	800	0.7	3.2	0.7	135,300	1,500	1.1	4.3	0.8
CS: Education, medical & other health & welfare service	348,700	4,900	1.4	9.8	4.3	274,800	4,000	1.5	8.8	2.2
CS: Other services	479,500	8,100	1.7	13.5	7.2	325,300	11,300	3.5	10.4	6.2
Others	21,700	700	3.2	0.6	0.6	28,700	900	3.1	0.9	0.5
Total	3,546,600	112,800	3.2	100.0	100.0	3,131,100	181,000	5.8	100.0	100.0

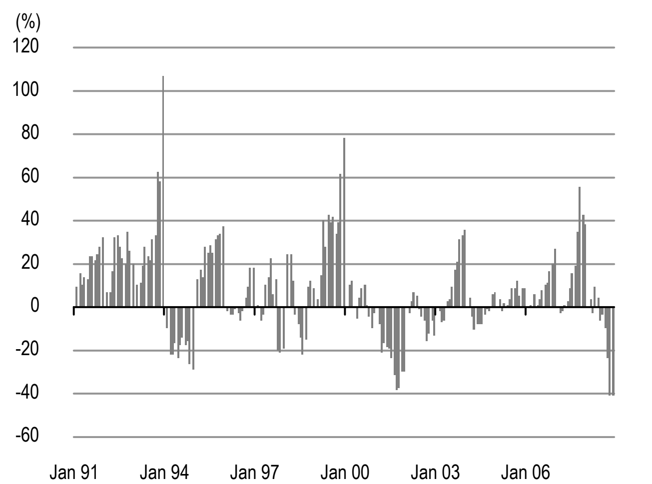
Source: CEIC

Wealth creation

Given the high correlation between the property and stock markets, the interlinked wealth effect is considered enormous. In fact, stock market returns tend to lead the property market by about 8-12 weeks with a 58% correlation. The positive wealth effect during the 1997 property market peak was much stronger considering the yearly returns from the stock market since 1991 were all positive, except in 1994, until the Asian financial crisis began in September 1997. Similarly, the stock market provided decent returns between 2003 and the beginning of 2008. Having said that, the momentum of this positive wealth impact has started to fade, as the property market peaked in June 2008. The dramatic correction in the stock market is likely to provide a big cap on the property market for the next three to six months. The de-leveraging of structured financial products in the market, which were one of the hottest investment choices at the beginning of 2008, is likely to be a drag on the purchasing or investment appetite for high-grade properties.

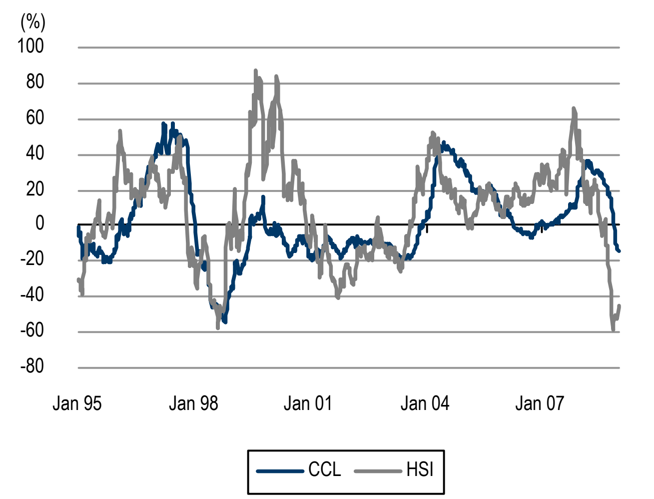
Stock market returns tend to lead the property market by about 8-12 weeks with a 58% correlation

Figure 55: HSI – cumulative yearly return



Source: CEIC, company data, Credit Suisse estimates

Figure 56: HSI versus CCL YoY %



Source: CEIC, Centadata, company data, Credit Suisse estimates

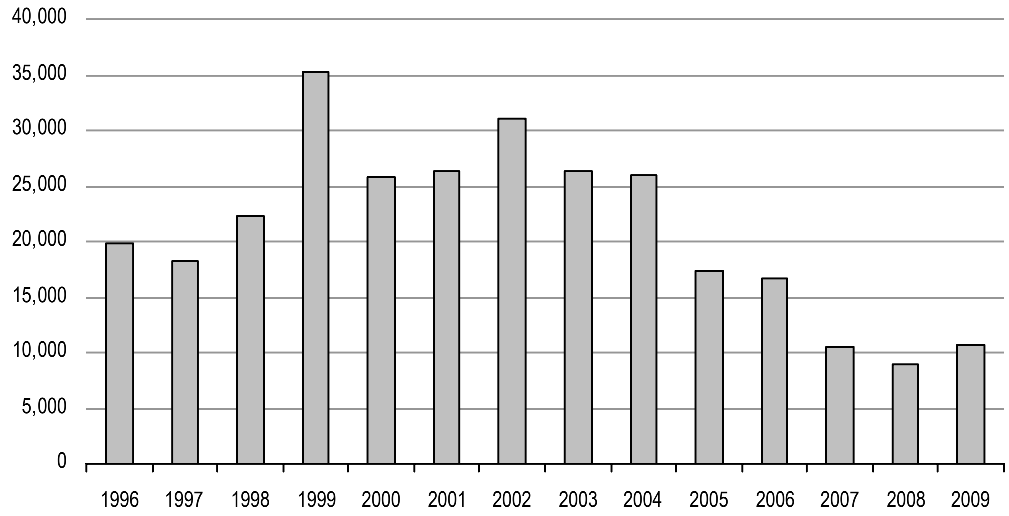
Supply

The limited number of residential units to be completed in the coming few years is one of the key reasons for our belief that the current property market downturn will not be as severe as the previous one. The supply of residential units estimated by the government in 2008 and 2009 is 8,940 and 10,670, respectively, while the average annual supply of the last ten years was about 23,000 units.

The supply of the residential units estimated by the government in 2008 and 2009 are 8,940 and 10,670, respectively

While we do not yet have the latest forecasts from the government for the new supply coming through in 2010, judging from the commencement of work granted in 2007 and 2008, we would expect the supply level to be at around 10,000 units.

Figure 57: Residential supply remains at low level in 2009

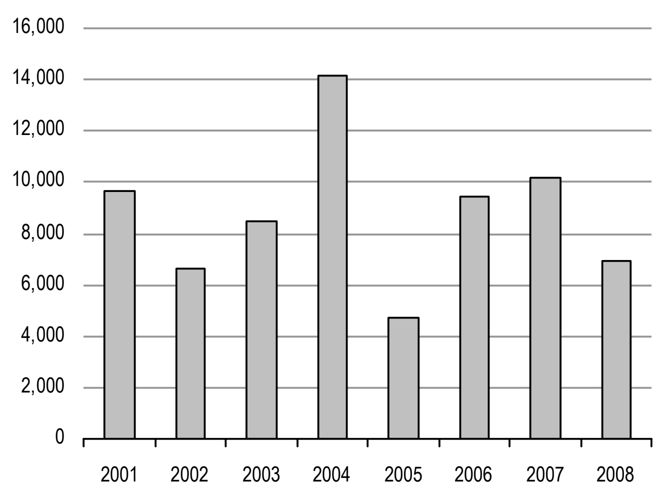


Source: HK Government, Company data, Credit Suisse estimates

To a large extent, the fall in the supply of residential units is driven by the government's stance on land supply. The amount of land sales through land auction has fallen substantially since 2001. Through the use of an application list system, the government has been criticised by developers of having a tough stance on the floor price of the land and effectively adopting its previous high land price policy. The result is that there will be a squeeze in residential unit supply in the medium term, which could help to cushion the downside for the residential market.

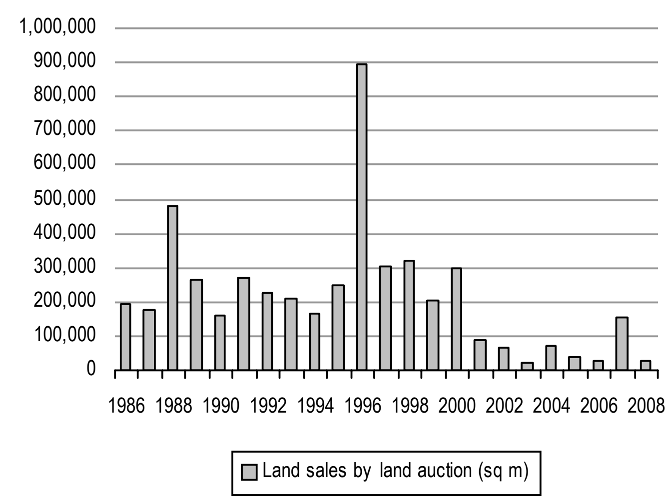
The significant property price correction after the Asian financial crisis was driven by shrinkage in demand as both end-users and investors lost their financial ability to buy. However, the significant increase in supply from both the private and public sectors also aggravated the downward adjustment cycle. In 2008, although demand also started to fade, driven by the negative wealth effect and the rise in unemployment, residential supply is limited and counters this fall in demand.

Figure 58: Commencement of works granted (units)



Source: CEIC, Company data, Credit Suisse

Figure 59: Land sales by auction (sq metres)



Source: CEIC, Company data, Credit Suisse

Demographics

Although the basic demographics in Hong Kong has not changed much over time, with average population growth of only about 0.7% over the past 12 years, the number of households formed has been quite steady at an average of 37,500 per year. The rise in the number of marriages since 2003 has also led to a small baby boom since 2005. For the past 12 years, the annual average take-up of primary private and public residential sales was 25,000 per year.

The number of households formed has been quite steady at an average of 37,500 per year

This sort of average annual demand may not necessarily be realised when the economy is in the doldrums. However, steady household formations from new marriages and the increase in net births should transform into strong pent-up demand once the economy stabilises. In any case, when the annual supply of primary residential units amounts to only an average of 10,000 units per year, we expect a strong supply/demand imbalance is in the making. With the right ingredients in place, i.e., a stable economy, improving stock market, persistent low interest rate environment with a better credit outlook, we believe there is a risk that the property market could *encounter* another asset price boom.

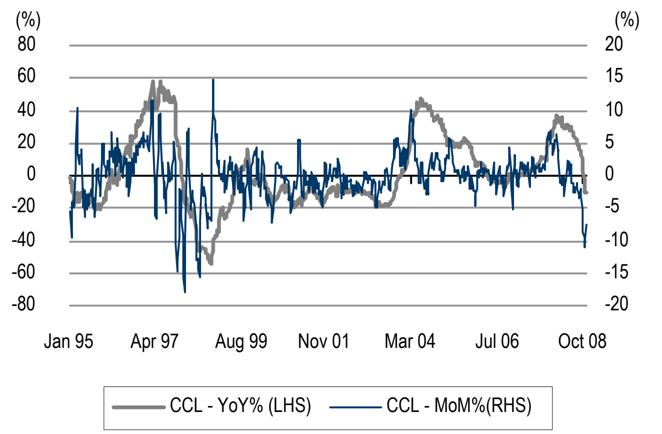
Figure 60: **Household formation number exceeds take-up of primary residential units**

	Marriage	New birth	Household formation	Annual take-up
1996	37,042	32,550	79,400	22,557
1997	37,593	28,300	49,000	34,210
1998	31,673	20,676	39,300	46,408
1999	31,287	17,126	34,900	27,342
2000	30,879	19,727	52,400	25,301
2001	32,825	15,839	16,500	26,869
2002	32,070	13,803	33,900	26,754
2003	35,439	11,266	28,900	28,264
2004	41,377	11,592	38,400	26,885
2005	43,018	18,441	17,900	15,866
2006	50,314	27,780	37,100	13,824
2007	47,453	30,431	12,500	20,060
2008	30,170	29,122	48,400	9,956
Average	**37,011**	**21,281**	**37,585**	**24,946**

Source: CEIC

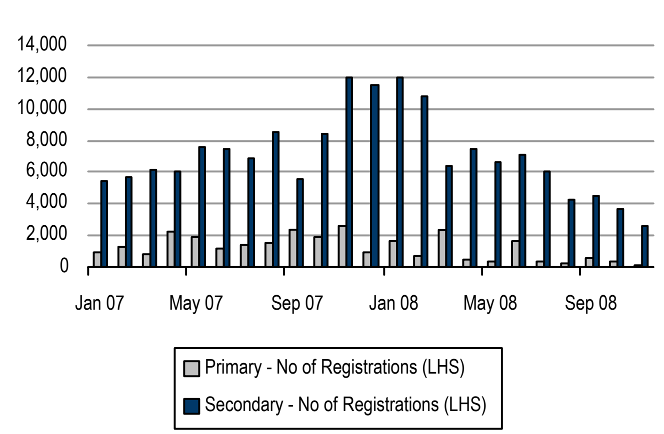
Latest trends in residential market

Figure 61: CCL YoY and MoM change



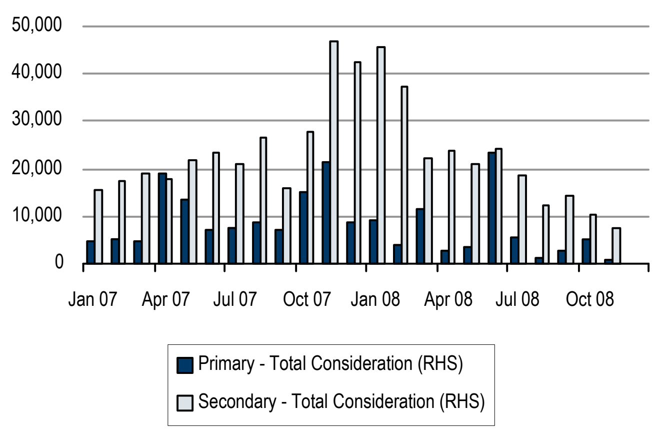
Source: Centadata

Figure 62: Transaction volume (no. of registrations)



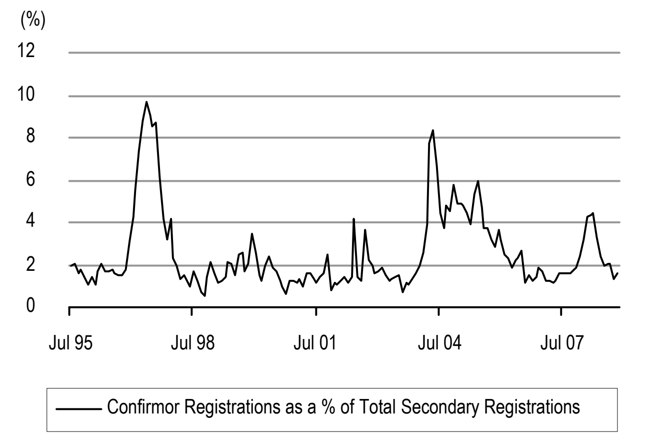
Source: Centadata

Figure 63: Transaction volume (monetary value)



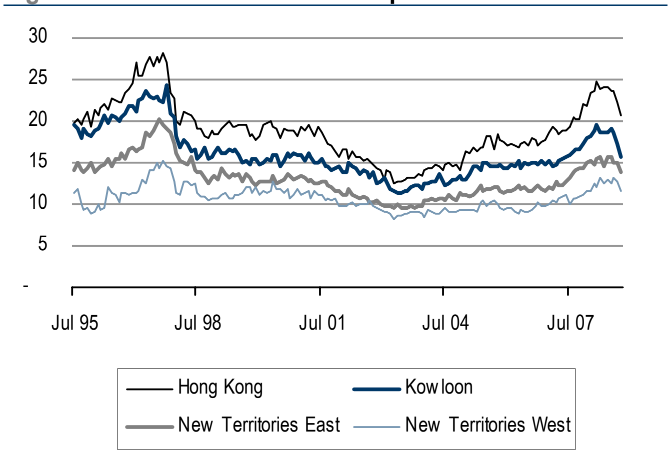
Source: Centadata

Figure 64: Confirmor registrations (% of total secondary registrations)



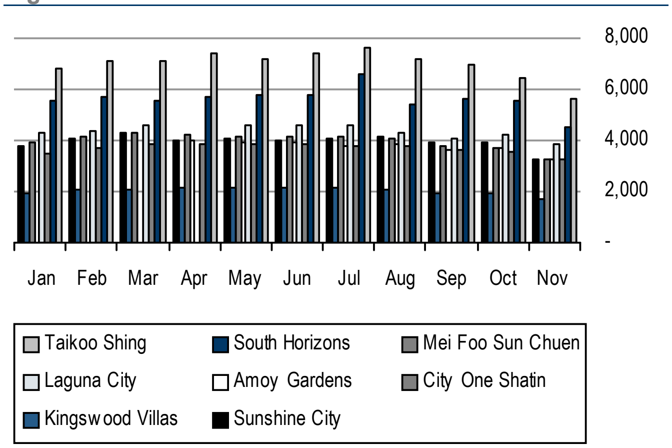
Source: Centadata

Figure 65: Rental trends for the top 50 residential estates



Source: Centadata

Figure 66: ASP for selected residential estates



Source: Centadata

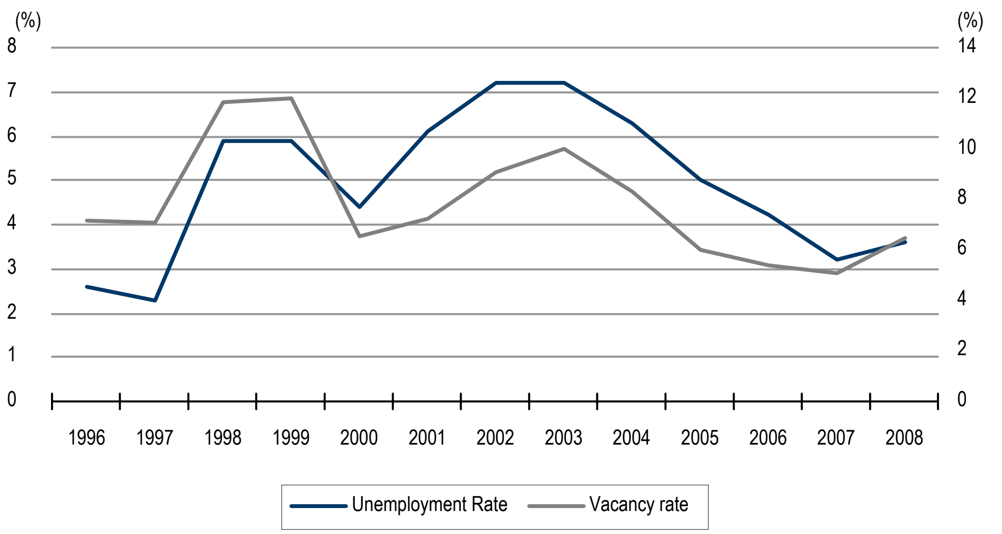
Office downside in 2009

Rents not falling yet but demand softening quickly

According to Jones Lang LaSalle's numbers and our conversations with the major landlords, office rent stayed firm in 3Q FY08, with Central office rents edging up about 1%. New demand has definitely slowed down, but there are no signs of major negative take-up yet. However, we believe the real impact on the office market from the economic slowdown and the rise in unemployment will take time to filter through. The local unemployment rate has just started to move up and is still hovering at less than 4%. The last time, when we saw the unemployment rate hit 6% in 1998, the overall office vacancy rate was close to 12%, compared with 6% now.

We believe the real impact to the office market from the slowing in the economy and the rise in unemployment will take time to filter through in 2009

Figure 67: Unemployment rate drove office vacancies



Source: CEIC, Company data, Credit Suisse

Assuming there is no take-up of new additions in 2009, we expect the overall vacancy rate for office property to go up to about 12.2%, with Kowloon East being the hardest hit area, as 191,101 sq m of supply is expected to be completed in 2009. Also, its vacancy rate is likely to go up to 41% from 28% if there is no positive take-up. With the same assumption, the vacancy rate in TST should rise from the current 4.5% to 15.6%, with the addition of 127,667 sq m from ICC. Fortunately, most of the ICC building has already been pre-leased, so the new space will not really be hitting the market hard.

Assuming there is no take-up of new additions in 2009, we expect the overall vacancy rate for office to rise to about 12.2%

Figure 68: Office vacancy rates scenario: 3Q08 actual versus FY09 base case versus FY09 worst case

(sq m)	Central	Wanchai	TST	HKE	Kln East	Total
3Q08 total stock	2,109,715	1,428,437	970,293	981,898	886,934	6,377,279
3Q08 total vacancy	39,795	33,477	43,395	20,950	247,411	385,029
3Q08 vacancy rate (%)	1.9	2.3	4.5	2.1	27.9	6.0
2009 major addition	66,535	18,587	127,667	47,482	191,101	451,372
2009 estimated total stock	2,176,250	1,447,025	1,097,961	1,029,380	1,078,035	6,828,651
Base case 2009 vacancy rate (assuming no take-up for 2009 addition) (%)	**4.9**	**3.6**	**15.6**	**6.6**	**40.7**	**12.2**
If assume negative take-up as in 2001 and 2002	(26,060)	(45,698)	(751)	(42,706)	(1,343)	(116,558)
Worst case 2009 vacancy rate (%)	**6.1**	**6.8**	**15.6**	**10.8**	**40.8**	**14.0**

Source: JLL, company data, Credit Suisse estimates

We expect a 35% fall in Central office rents

Despite the resilience of Central office rents so far, we expect this to decline by about 35% in 2009. Based on the 3Q FY08 headline effective rent of HK$115/sq ft, as reported by Jones Lang LaSalle, and assuming rents to stay flat in 4Q08, we expect it to drop to about HK$75/sq ft level. In our earnings forecasts, we had forecast the reversion rents for some other Central grade-A office buildings to be about HK$45-50/sq ft. We arrived at this by assuming that the financial industry will continue to contract in 2009. There is certainly upside risks to this. Assuming that China's economy revives in 2H09 and the prospects for the equity market improve, a potential increase in the IPO pipeline could rejuvenate demand for office space from the financial services sector.

Based on the 3Q08 headline effective rent of HK$115/sq ft, as reported by Jones Lang LaSalle, and assuming rents stayed flat in 4Q08, we expect the level to drop to about HK$75/sq ft

Figure 69: Major new offices in FY09

District	Project name/address	Approx. GFA (sq ft)
Sheung Wan	242 Des Voeux Road	48,738
Central	3 Connaught Road	225,000
Central	50-59 Connaught Road	172,270
Central	31 Queen's Road Central	178,280
Central	39 Queen's Road Central	140,370
Causeway Bay	500 Hennessey Road	200,000
Quarry Bay	863 - 865 King's Road	510,901
TST	ICC (Phase 2 and 3)	1,373,701
Kowloon Bay	1 Wan Kong Road	539,290
Kowloon Bay	19 Wan Chiu Road	348,700
Kwun Tong	7 Shing Yip Street	360,000
Kwun Tong	79 Hoi Yuen Road	240,000
Kwun Tong	414 Kwun Tong Road	240,000
Kwun Tong	Millennium City 7	328,252
Kwai Chung	Kowloon Commerce Centre (Phase 2)	497,000
Total		**5,402,502**

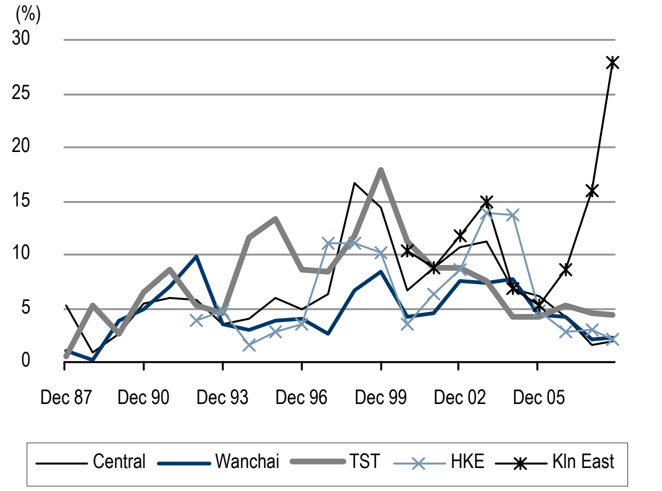
Source: HKET, company data, Credit Suisse estimates

Our view on playing the decentralised office exposure is a relative call to the Central office market, to which we believe office rents in TST and Island East will fall in a smaller magnitude. While Central office rents are still at a high level, its rental gap with the decentralised areas such as Island East remains at a historically high level. Traditionally, decentralised office areas are less sensitive to contractions in the financial services sector. The only exception was in 2003, when there was a significant supply of grade-A office space from IFC II, which made Central office rents fall below HK$20/sq ft, while Island East was at HK$11/sq ft. This caused a major "centralisation" trend on the back of this narrowed rental gap.

The significant increase in grade-A office supply in Kowloon East would, of course, raise concern on an overall rise in vacancy rates. Despite its attractively priced rental level, we are not seeing Kowloon East pulling any major tenants out of the traditional office areas yet.

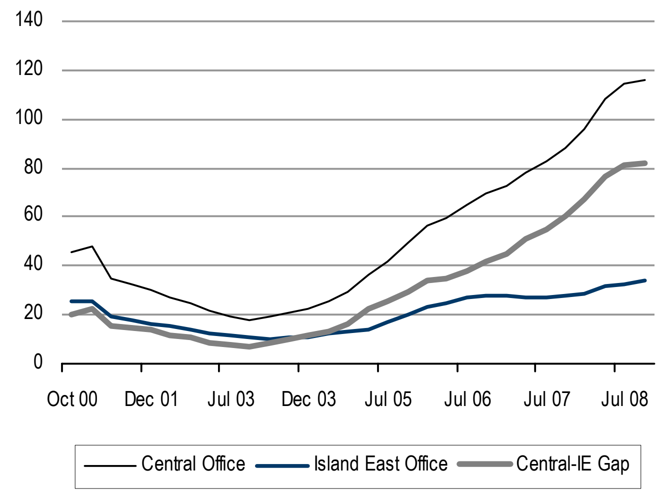
Overall, we expect rents in decentralised areas such as TST and Island East to fall by about 25% to HK$32/sq ft and HK$34/sq ft, respectively, at the end of 2009.

Figure 70: Office vacancy rates by district



Source: JLL, company data, Credit Suisse estimates

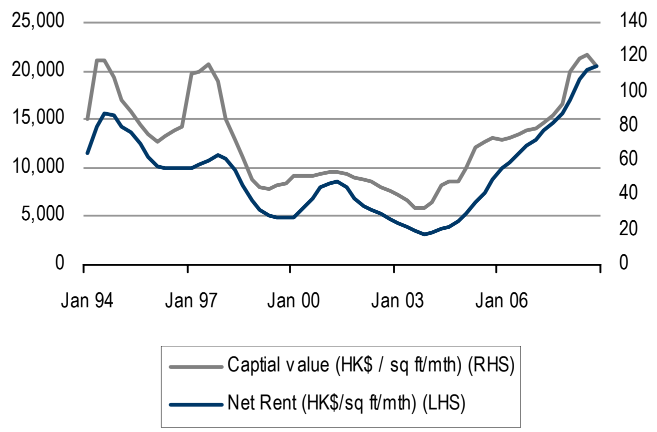
Figure 71: Average rent per sq ft/month – Central versus decentralised office (illustrated by Island East district)



Source: JLL, company data, Credit Suisse estimates

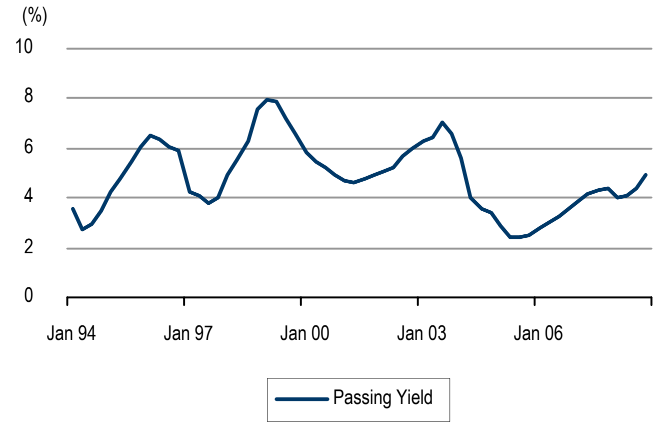
Latest rental trend

Figure 72: Central – capital values and rental level



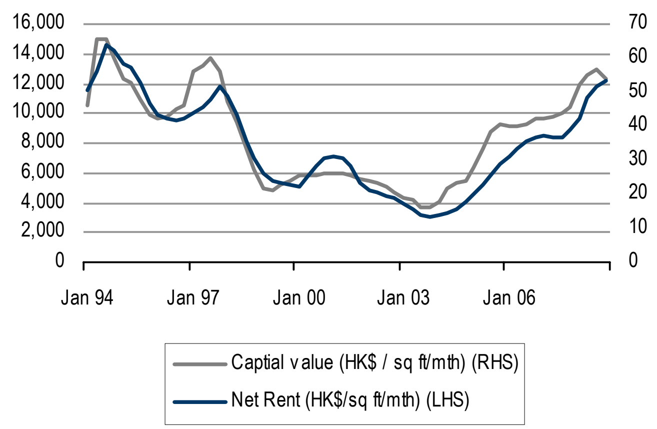
Source: JLL, company data, Credit Suisse estimates

Figure 73: Central – passing yield



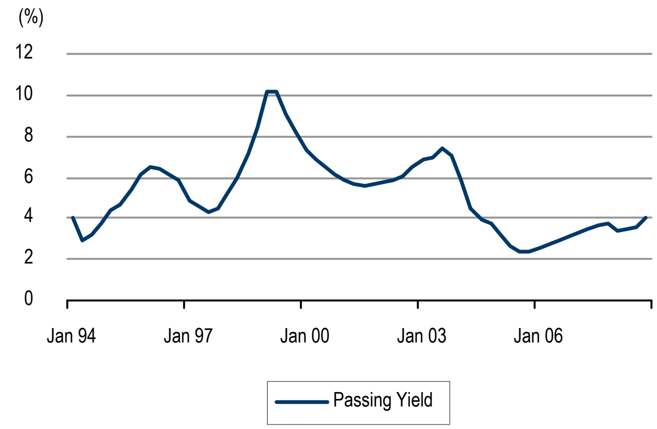
Source: JLL, company data, Credit Suisse estimates

Figure 74: Wan Chai – capital values and rental level



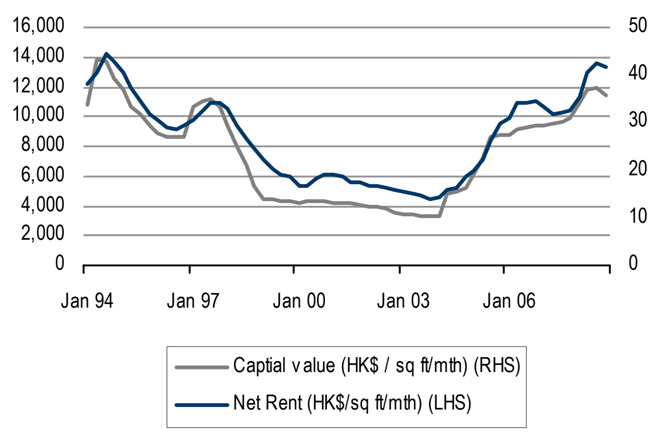
Source: JLL, company data, Credit Suisse estimates

Figure 75: Wan Chai – passing yield



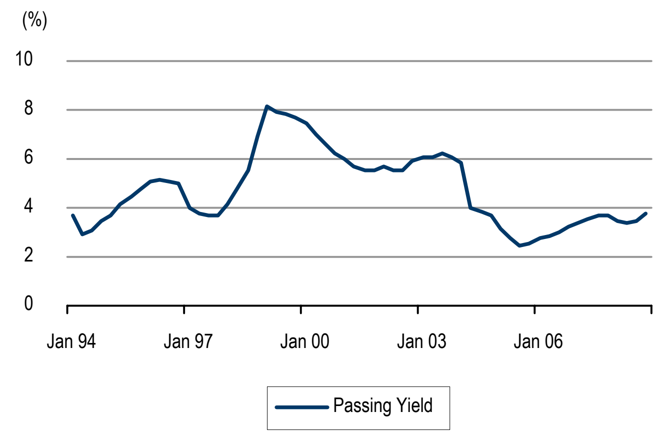
Source: JLL, company data, Credit Suisse estimates

Figure 76: TST – capital values and rental level



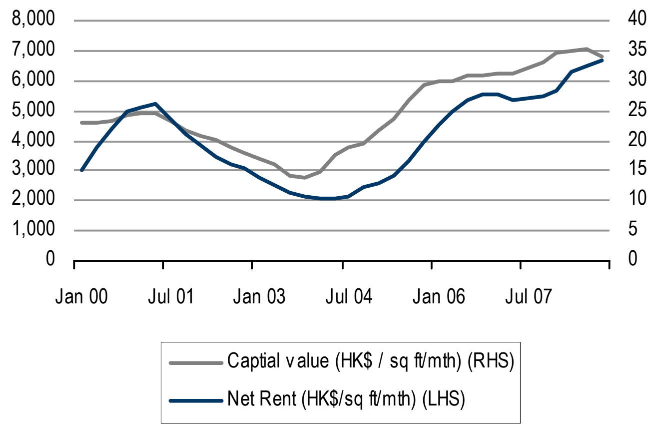
Source: JLL, company data, Credit Suisse estimates

Figure 77: TST – passing yield



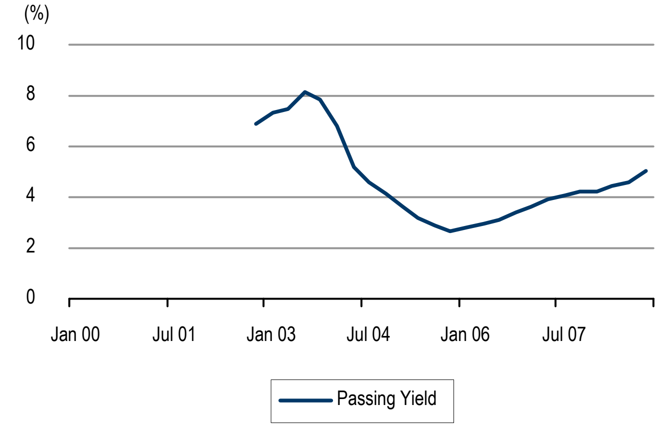
Source: JLL, company data, Credit Suisse estimates

Figure 78: Island East – capital values and rental level



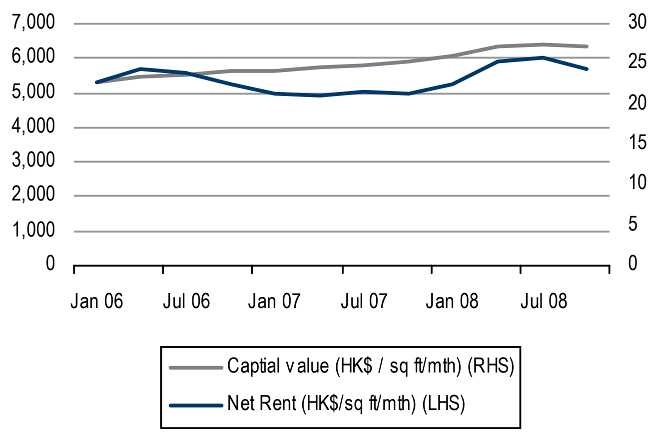
Source: JLL, company data, Credit Suisse estimates

Figure 79: Island East – passing yield



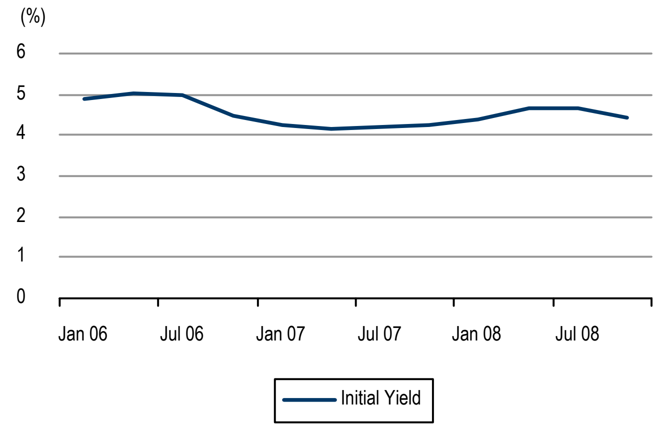
Source: JLL, company data, Credit Suisse estimates

Figure 80: Kowloon East – capital values and rental level



Source: JLL, company data, Credit Suisse

Figure 81: Kowloon East – passing yield



Source: JLL, company data, Credit Suisse

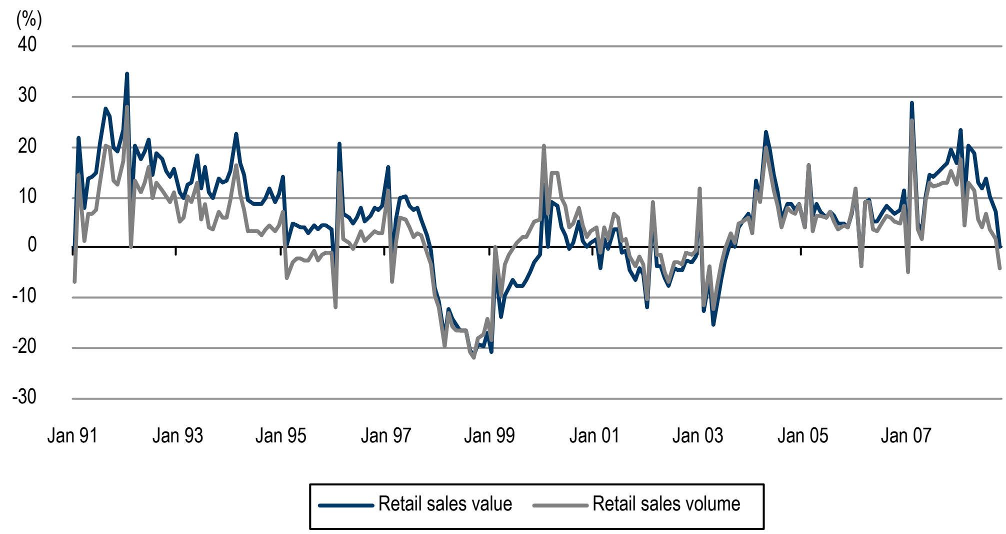
Retail rents under pressure

Consumer durables are the hardest hit areas

Along with the negative wealth impact and rising unemployment rate, Hong Kong retail sales growth was down to 0% and -4% in October in terms of value and volume, respectively. The hardest hit areas are clothing and apparel (-7%), consumer durables (-7%), motor vehicles (-23%), jewellery and watches (-2%). These are high-value-added items, which are expected to be most affected when the wealth of higher-income classes are affected by the negative the wealth effect from the stock market. During the last downturns in 1998 and 2003, retail sales dropped by as much as 20% and 13%, respectively. Similar to the office market, we have yet to see the worst, as retail sales and rents tend to lag.

The hardest hit areas of slowing retail sales are clothing and apparel (-7%), consumer durables (-7%), motor vehicles (-23%), jewellery and watches (-2%)

Figure 82: **Retail sales value and volume on a downward trend**



Source: CEIC

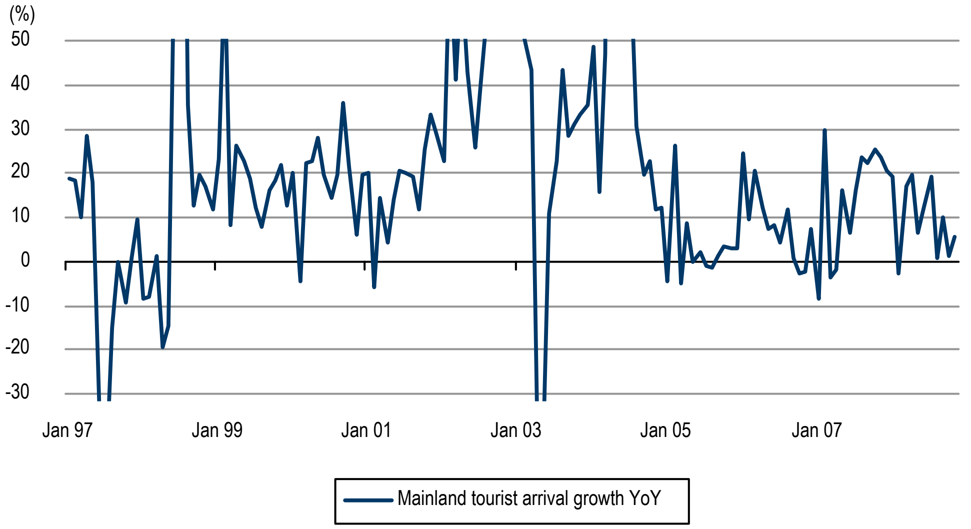
Mass and prime retail rents to fall by 20% and 15%

We would not be surprised to see retail rents of mass and prime shopping malls fall by 20% and 15%, respectively, in 2009, although most major landlords are not feeling major downward pressure on rents yet. The “turnover rent” portion, though, will probably be eroded quickly. Our view on the slightly smaller fall in retail rent for prime shopping malls is based on: 1) the increasing polarisation between prime and non-prime shopping malls during a downturn and 2) the support from mainland tourist spending in Hong Kong. Regarding mainland tourist arrivals, although growth is likely to slow, due to the economic slowdown, the opening up of more geographical coverage from the expansion of the individual visitor scheme is likely to provide a strong cushion to shopping malls that are key destinations for Chinese tourists.

Our view on the slightly smaller retail rent fall for prime shopping malls is based on the increasing polarization between prime and non-prime shopping malls during a downturn and the support from mainland tourist spending in Hong Kong

We believe that traditionally large shopping malls such as Harbour City, Times Square, Pacific Place and Langham Place will continue to do relatively well due to the support from tourist traffic. Furthermore, localised shopping centres that cater mainly to the daily needs of local residents should also prove to be more defensive. However, smaller shopping malls could be more prone to a rise in vacancy rates as their tenants tend to be financially weaker to sustain a prolonged downturn. The tenants of prime malls, though, are usually more established brand names with stronger balance sheets and may weather this sort of environment better. The chance of the tenants “failing” is relatively small in this regard, in our view.

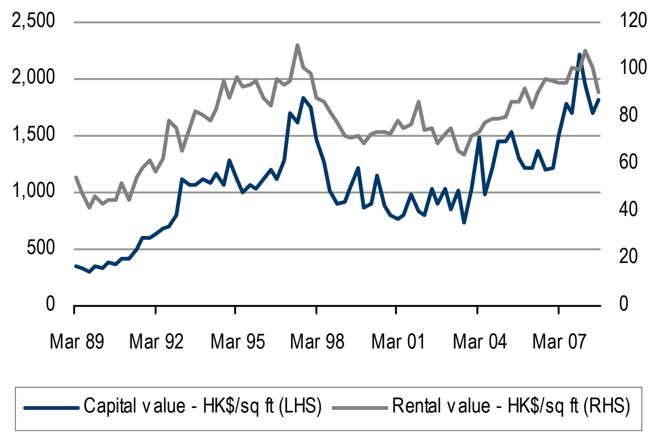
Figure 83: YoY % change in tourist arrivals to Hong Kong



Source: CEIC

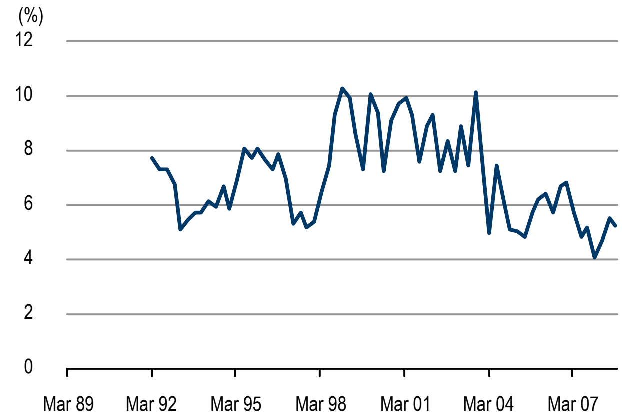
Latest rental trend

Figure 84: **Hong Kong – capital value and rental level**



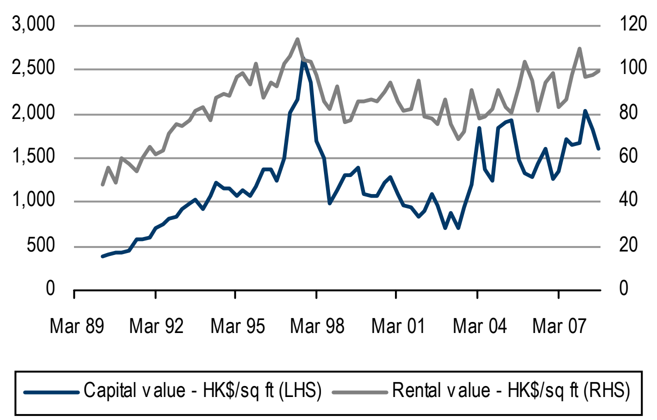
Source: JLL, company data, Credit Suisse estimates

Figure 85: **Hong Kong – passing yield**



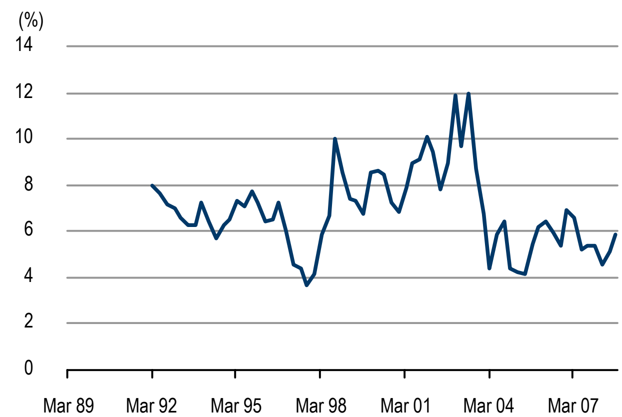
Source: JLL, company data, Credit Suisse estimates

Figure 86: **Kowloon – capital value and rental level**



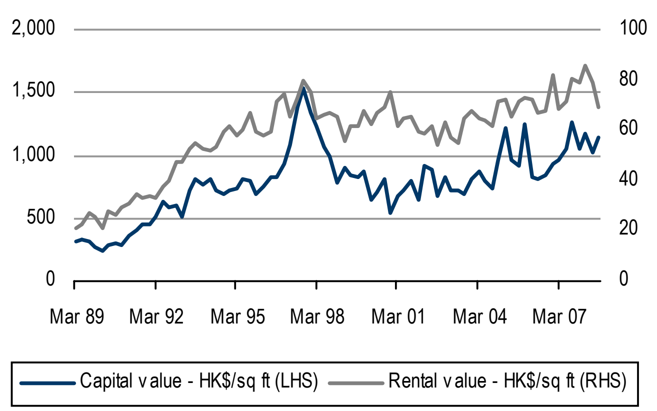
Source: JLL, company data, Credit Suisse estimates

Figure 87: **Kowloon – passing yield**



Source: JLL, company data, Credit Suisse estimates

Figure 88: **New Territories – capital value and rental level**



Source: JLL, company data, Credit Suisse estimates

Figure 89: **New Territories – passing yield**

Source: JLL, company data, Credit Suisse estimates

Companies Mentioned *(Price as of 05 Jan 09)*
Bank of East Asia (0023.HK, HK$17.08, NEUTRAL [V], TP HK$18.00)
BOC Hong Kong (Holdings) (2388.HK, HK$9.13, NEUTRAL, TP HK$10.00)
Cheung Kong Holdings (0001.HK, HK$81.00, OUTPERFORM, TP HK$91.30)
Citi (C, $7.14, NEUTRAL [V], TP $10.00)
C-REIT (2778.HK, HK$2.18, NOT RATED)
Great Eagle Hdg. (0041.HK, HK$9.34, OUTPERFORM [V], TP HK$19.97)
Hang Lung Properties (0101.HK, HK$18.98, NEUTRAL [V], TP HK$19.09)
Henderson Land Dev (0012.HK, HK$30.85, NEUTRAL, TP HK$28.26)
Hongkong Land Holdings (HKLD.SI, $2.63, UNDERPERFORM, TP $2.07)
HSBC Holdings (0005.HK, HK$77.50, NEUTRAL, TP HK$98.00)
Hutchison Whampoa (0013.HK, HK$42.50, OUTPERFORM, TP HK$69.20)
Hysan Development Co. (0014.HK, HK$13.24, NEUTRAL, TP HK$13.83)
ICBC (Asia) Limited (0349.HK, HK$8.89, OUTPERFORM [V], TP HK$11.00)
Kerry Properties (0683.HK, HK$21.35, NEUTRAL [V], TP HK$24.04)
Liu Chong Hing Bank Limited (1111.HK, HK$9.72)
MTR Corporation (0066.HK, HK$17.94, OUTPERFORM, TP HK$24.87)
New World Development (0017.HK, HK$8.75)
Sino Land (0083.HK, HK$8.76, NEUTRAL [V], TP HK$8.28)
Standard Chartered Plc (2888.HK, HK$99.65, NEUTRAL, TP HK$85.00)
Sun Hung Kai Properties (0016.HK, HK$70.30, OUTPERFORM [V], TP HK$84.06)
Swire Pacific 'A' (0019.HK, HK$57.00, OUTPERFORM, TP HK$75.90)
Wharf Holdings (0004.HK, HK$22.70, OUTPERFORM [V], TP HK$28.06)

Disclosure Appendix

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CREDIT SUISSE (Hong Kong) Limited
Asia/Pacific: +852 2101-6000