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LEGISLATIVE COUNCIL BRIEF

Divestment of Housing Authority's Retail and Car-parking Facilities

INTRODUCTION

At the meeting of the Executive Council on 15 July 2003, the Council ADVISED and the Chief Executive ORDERED that-

(a) we should seek the Housing Authority's (HA) agreement in principle to divest its retail and car-parking (RC) facilities;

(b) the net proceeds from the divestment in principle should entirely go to HA to meet its budget deficit for the short term;

(c) for the purpose of the divestment, we should grant to HA the land of the public rental housing estates on which the RC facilities are built by way of leases, and nominal premium should be charged for granting such leases with provisions made for allowing the assignments of the RC facilities at nil premium to the new company as mentioned at paragraph 8(a) below and, where leases have already been granted to HA, for allowing assignment of the RC facilities to the said new company also to be at nil premium; and

(d) we should draw up a comprehensive manpower strategy to accommodate surplus staff arising from the divestment exercise by mid-2004.

JUSTIFICATION

(A) Withdrawal from commercial operation

2. Divestment of HA's RC facilities would enable HA to focus its resources on its core function as a provider of subsidized public housing. Furthermore, the facilities concerned are likely to generate better returns

under private sector ownership and operation, which will in turn have a positive impact on the overall economic development of Hong Kong.

(B) Tiding over budget deficit

3. Hitherto, the sale of HOS and TPS flats has generated sufficient income for HA to meet its capital expenditure on the production of public rental housing flats. Following the announcement of Government's new housing policy in November 2002, the production and sale of HOS flats have ceased indefinitely and the sale of TPS flats will be halted. In the absence of other replacement income sources, HA will incur an annual net cash flow deficit, and its cash balance is forecast to decrease from $22 billion at the beginning of 2003/04 to minus $5.5 billion by the end of 2005/06. Proceeds from the proposed divestment will help to meet HA's funding requirements in the short term, allowing it to pursue in the longer term various cost-saving initiatives to improve its financial position.

4. There is no viable option other than divestment to relieve HA of the responsibility for operating the RC facilities on a commercial basis.

5. If the HA does not divest its RC facilities, Government may need to provide substantial funds shortly to the HA to meet its serious cash flow deficit problem. This may not be practicable given that Government similarly has a significant fiscal deficit. Alternatively, the HA may raise debt capital against rental income generated from the RC facilities, with the facilities being pledged as collateral. However, the maximum amount of debt capital that can be raised in this way is likely to be no more than 40% to 50% of the value of the RC facilities, vis-à-vis up to 90% of the value under the divestment strategy proposed in paragraph 8 below.

PROPOSED DIVESTMENT STRATEGY

6. A number of divestment options have been considered which include traditional property company IPO and outright sale. These options are considered less desirable than the proposed divestment strategy in paragraph 8 below due to various reasons, including comparatively lower divestment proceeds, possible impact on the local property market, and lack of broad retail participation. Moreover, technical constraints, particularly in relation to the legal title of the RC facilities, also affect the choice of an optimal divestment strategy.

(A) Technical Constraints

7. As the land on which the RC facilities operate are generally vested in the HA by Government, in the first place the HA will need to acquire the relevant land leases for the purpose of the divestment. Since these facilities are generally integral to public housing estates[Note 1], Government cannot grant leases for the facilities in isolation. As a result, land leases together with the necessary Deeds of Mutual Covenant in respect of some 130 rental estates will have to be procured. The processing of these documents will take a few years to complete, subject to sufficient resources being made available to relevant Departments[Note 2].

(B) Proposed strategy

8. To tackle the above intrinsic constraint, the following broad strategy to take forward divestment is recommended -

(a) a new company with characteristics[Note 3] of a 'Real Estate Investment Trust' (REIT) will be established;

(b) initially, the HA will assign the cash flow of the RC facilities to this company and sign a sale and purchase agreement with it in respect of the RC facilities. On this basis, the company will make an initial public offering (IPO) on the Stock Exchange of Hong Kong;

(c) at a later stage when preparation of relevant leases are completed, the HA will transfer the legal title of the RC facilities to the company; and

(d) the company will pay to the HA for the sale of the RC facilities by two instalments : a majority proportion of the sale amount will be paid immediately after the IPO; the balance will be paid upon transfer of the legal title.

[Note 1] *Public housing estates include rental estates, TPS estates, HOS courts, and housing estates covered by the Mortgage Subsidy Scheme or Buy or Rent Option Scheme.*

[Note 2] *These refer to Lands Department, Buildings Department and Government Property Agency.*

[Note 3] *These characteristics refer mainly to: (a) a focused business strategy; (b) a clear dividend policy which pays out the majority of the net earnings; (c) a conservative gearing policy; and (d) restrictions on speculative development. Some degree of flexibility would be maintained on whether the new company should be a REIT or one with REIT characteristics as the Securities and Futures Commission is now considering regulations for REITs with a view to allowing such investment vehicles in Hong Kong.*

9. The proposed divestment strategy will enable the HA to realize the divestment proceeds within a relatively short time frame. The company's REIT-like characteristics will also attract valuations of the company close to its net asset value. Moreover, the proposed strategy will provide an opportunity for investors' participation in the ownership of the RC facilities through the capital market, and minimize the impact of the divestment on the local property market. The risk of disruption to existing tenants and services will be low, and the HA staff will be provided with an opportunity to seek employment with the company which will have to recruit a good proportion of its key personnel from the HA in order to meet the track record requirements for the purpose of the IPO.

10. A conservative stock with strong cash-flow and high dividend yield as in our case will be particularly attractive to investors in a low interest rate environment, where investors generally look for dividend yield rather than growth. Despite the economic downturn, the proposed IPO will enjoy attractive valuation if it could capitalize on the prevailing low-interest rate cycle, which, according to general market assessment, is likely to continue for some time.

RELATED ISSUES

(A) Divestment proceeds

11. Under the current financial arrangements between Government and HA, the value of land for the non-domestic portion of public rental housing estates and HOS courts is treated as Government's equity investment in HA. The return on this investment is reflected in the Government receiving 50% of the net operating surplus generated from HA's non-domestic operations.

12. Although Government has a financial stake in HA's RC facilities, we recommend that in principle all the net proceeds from the proposed divestment should go to HA for meeting its cash flow deficit for the short term arising from the cessation of sale of HOS and TPS flats as explained in paragraph 3 above.

(B) Land lease and government rent

13. To enable the transfer of legal title of the RC facilities to the new company, we recommend that Government grant leases to HA at nominal premium with provisions made for allowing the assignments of the RC

facilities at nil premium to the new company mentioned at paragraph 8(a) above. For RC facilities in HOS, TPS, Mortgage Subsidy Scheme and Buy or Rent Option estates, leases have already been granted to HA in respect of the land concerned. These leases currently contain non-assignment clauses applicable to the RC facilities. We recommend that, for the purpose of the divestment, nil premium should be charged for allowing assignment of the RC facilities in question.

14. New leases of land are normally granted subject to payment of government rent. After the leases are granted, the new company will need to pay government rent in respect of the RC facilities. However, Government intends to have an administrative arrangement with HA such that Government rent payable by HA in respect of the non-commercial portion of land subject to the land leases is not demanded or is waived.

(C) Scope of RC facilities to be divested

15. A preliminary appraisal indicates that a small proportion of the HA's RC facilities may be unsuitable for transfer to the new company because of their poor location, small scale, old age or obsolescent condition. Alternative means will have to be devised to deal with these properties on a case-by-case basis, such as outright sale or change to other designated uses.

(D) Divested RC facilities subject to Buildings Ordinance control

16. At present, all properties of the HA and Government are exempted from control by the Building Authority. After the divestment, such exemption will no longer apply to the RC facilities. For the purpose of the divestment, we will have to compile plans and records of the RC facilities to facilitate future building control, and identify and arrange for implementation of consequential works, if any, to demonstrate that the standards set down in the Buildings Ordinance and other allied statutory building requirements are met.

STAFFING ARRANGEMENTS

17. The divestment proposal would affect about 500 departmental and 200 general grade and contract posts in HA, ranging from professional to front-line grades/ranks. As soon as the divestment proposal is made public, HA will start extensive consultation with the departmental and contract staff concerned. The Civil Service Bureau (CSB) will also render their advice in this respect.

18. In its initial phase of operation and pending the recruitment of its own staff, a majority of the existing HA staff are likely to support the new company through, possibly, temporary secondment or service contracts. There will be opportunities for HA staff to be recruited by the new company given their operational knowledge and experience, especially to meet the management track record requirements for the purpose of listing. The HPLB and HA will formulate a manpower strategy in consultation with CSB before the establishment of the new company in mid-2004.

WAY FORWARD

19. We intend to submit the proposal to HA at a special meeting to be held on 24 July 2003. After obtaining HA's agreement in principle, we will proceed to appoint the global coordinator(s) and other necessary consultants as promptly as possible to assist in implementing the divestment. The appointments will be made through tendering in an open and transparent manner. We will provide adequate briefing to potential bidders. Our current plan is to set up the new company and to list it on the Hong Kong Stock Exchange in 2004/05.

IMPLICATIONS OF THE PROPOSAL

20. The proposal will have a significant impact on the career prospect of some 700 HA staff. Detailed financial, staffing, economic, and
A sustainability implications of the proposal are set out at **Annex A**.

21. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. It has no productivity or environmental implications.

PUBLIC CONSULTATION

22. In the Policy Agenda published in January 2003, we announced that we would evaluate divestment options for the RC facilities with a view to developing an implementation plan. Subsequently, there was moderate discussion on this at the Legislative Council Housing Panel. We have not yet consulted stakeholders on the details of the proposal. We will put in place appropriate arrangements for staff consultation, which will begin after HA agrees in principle to the divestment. Tenants of the RC facilities, representatives from various housing concern groups and resident groups, the

real estate industry, academics and political parties will also be consulted.

PUBLICITY

23. We will issue a Legislative Council brief. A spokesman will be available to handle media enquiries. We will arrange briefings for stakeholders shortly after HA approves the divestment proposal in principle.

BACKGROUND

24. HA currently holds approximately one million square meters of retail facilities and some 100 000 car-parking spaces, amounting to some 11% and 16% of the market respectively.

25. Divestment of HA's RC facilities was first mooted by a consultant commissioned by HA in 2000, and was recommended by the Report on the Review of the Institutional Framework for Public Housing published in June 2002. Thereafter, a consultant was appointed to study various options for the divestment and to recommend the way forward. The divestment strategy outlined in paragraph 8 above is based on the findings of
B this consultancy study. A consultancy summary is at **Annex B**.

ENQUIRIES

26. For enquiries, please contact Ms. LAM Lit-kwan, Assistant Director of Housing (Divestment) at 2761 5158.

Housing Department
Housing, Planning and Lands Bureau
July 2003

IMPLICATIONS OF THE PROPOSAL

Financial Implications

Based on the consultant's preliminary estimate, divestment of the HA's RC facilities will generate net proceeds of over $20 billion[Note 1]. The actual valuation will be conducted by the global coordinator(s) to be appointed, taking into account factors including market conditions at the time of the IPO, perceived value enhancements, and expected yield by potential investors. It should be noted that given the variables involved here (such as prevailing market conditions at the time of IPO), there will be flexibility, as it should, in the final valuation. Notwithstanding that, we should endeavour to ensure that the valuation is based on real market situations, and there is no question of launching the IPO below fair market price.

2. At present, rental income from the RC facilities is a major source of recurrent cash flow to the HA to fund its recurrent operating expenditure. The loss of this steady source of income after the divestment will mean that the HA must find alternative means to balance its recurrent operating budget. The exact impact cannot be quantified at this stage as the HA is pursuing in parallel various initiatives to reduce its operating cost.

3. To deal with the legal title and building control issues as mentioned in paragraphs 7 and 16 of the memorandum would have financial and staffing implications for the HA, Lands Department, Buildings Department and Government Property Agency. While it is not possible to quantify the exact requirements at this stage, additional resources either from the HA or the Housing, Planning and Lands Bureau's operating expenditure envelope may have to be provided to the concerned departments to complete the assignment within the specified timeframe.

4. Any specific exit package to be offered to civil servants in the HA to cater for the divestment (see paragraphs 5 and 6 below) will have financial implications. It is not possible to quantify them at this stage. If such a package is offered, the cost of the commuted pension and normal monthly pension will be absorbed by Government while the cost of any ex-gratia payment or enhanced monthly pension will be absorbed by the HA.

Staffing Implications

[Note 1] *Proceeds from IPO after deducting commissions, legal title costs, consultancy expenses and marketing expenses, but before deducting potential costs relating to anypossible staff exit packages.*

5. While it is premature to assess the number of staff likely to be recruited by the new company to be established, the divestment will probably result in surplus staff as the new company progressively phases in its own staff. The HA will make full use of the current voluntary retirement scheme and natural wastage to mitigate the potential surplus staff. In addition, it will explore all possible measures to deal with the problem. These measures include -

(a) developing re-deployment initiatives to absorb some of the staff;

(b) non-renewal/termination of agreements of contract staff;

(c) seconding staff to the Lands and Buildings Departments to take up work in those departments; and

(d) depending on the outcome of (a) to (c) above, consideration may be given to developing an exit mechanism to deal with any remaining surplus staff.

6. The HA will work with staff in developing arrangements for redeployment and other exit possibilities. While keeping options open, we will reassure civil servants that all possible means will be explored to facilitate those staff who wish to remain in the service to continue to have a career.

Economic Implications

7. The proposed divestment through forming a property holding company for the RC facilities and then making an IPO of its shares will bring forth a good opportunity for the investing public to place investment in a substantial portfolio of RC facilities with many positive attributes. Privatization of the RC facilities will be able to bring about improved efficiency of operations and avoid suppressed return imparted by social considerations, thereby unlocking the fuller potential value of these facilities. This will have a positive impact on property market development in Hong Kong, and will also reinforce our commitment to a free market and a small government. Furthermore, IPO of a new company with REIT-like characteristics would add diversity to Hong Kong's stock market.

Sustainability Implications

8. The proposal will help HA to tide over the budget deficit in the short term through the divestment of its profitable assets and Government giving up its

share of the divestment proceeds. However, whether the HA could achieve long-term financial sustainability while attaining the target average waiting time for allocation of public rental housing at three years or less would much depend on its capability to implement timely and effective cost-saving initiatives in the coming years. The concerns of its staff and the tenants of the RC facilities should be handled with care.

<u>**Annex B**</u>

Consultancy on the Divestment of Retail and Carparking Facilities
- Consultancy Summary -

香港房屋委員會
Hong Kong Housing Authority

Divestment of Housing Authority's
Retail and Car-parking Facilities

INTRODUCTION

The Hong Kong Housing Authority (the "HA"), established in April 1973 under the Housing Ordinance, is a statutory body responsible for implementing Hong Kong's public housing programme within the objectives of the Long Term Housing Strategy of the Government of the Hong Kong Special Administrative Region (the "Government"). Through its executive arm, the Housing Department (the "HD"), it plans and builds public sector housing, either for rent or sale. The HA manages the retail and car-parking ("RC") facilities developed by the HA which comprise of approximately one million sq.m. of retail properties and 100,000 carpark spaces making the HA the largest retail property and carpark facility owner in Hong Kong with market shares of approximately 11% and 16%, respectively.

RATIONALE FOR DIVESTMENT

2. The Divestment of HA's RC facilities was first mooted in 2000, with the objective of enabling the HA to focus its valuable resources on its core function as the provider of public housing in Hong Kong, in line with the clear direction provided in the Review of the Institutional Framework for Public Housing published in June 2002, where it recommends that the HA should progressively divest its non-core assets, i.e. the commercial portfolio (retail and carparking facilities).

3. In addition, the Divestment is also consistent with the HA's objective of 'streamlining its internal structure' as stated in the 2003 Policy Agenda, as well as providing the HA with additional funding.

THE CONSULTANCY

4. Thereafter, a consultancy study[1] was commissioned in July 2002 by the HA to assess the feasibility of the Divestment. In addition, the consultant has

[1] The Consultants include UBS Warburg and its sub-consultants DTZ Debenham Tie Leung and Clifford Chance were appointed as part of the Provision of Consultancy on the divestment of the HA's RC Facilities.

been requested to provide the recommended divestment strategy and formulate an implementation proposal.

ASSESSMENT OF ISSUES

5. Based on the information provided by the HA, the Consultants have identified and assessed a series of issues, which can be categorised into four major groups: property, legal and regulatory, finance and accounting, and other issues. These key issues form important considerations in formulating an optimal divestment strategy for the RC facilities.

FORMULATION OF THE OPTIMAL DIVESTMENT STRATEGY

6. In formulating the optimal divestment strategy, the Consultants has reviewed the various divestment options available to the HA which include a public offering through an initial public offering ("IPO") of shares of a company or a real estate investment trust ("REIT"), outright sale, securitisation, and other divestment options/combination of options available.

7. In evaluating these divestment options and formulating an optimal divestment strategy, the rationale for the Divestment and a wide range of qualitative and quantitative issues have been taken into account. These include social, stakeholders, operational, timing, legal, regulatory, financial and accounting concerns.

8. The most important considerations for the optimal divestment strategy are -

(a) to achieve divestment of the RC facilities portfolio within a reasonable timeframe while addressing the key stakeholders issues constructively, and achieving social and political acceptability.

(b) to be able to address issues relating to legal title and future building control of the RC facilities which may require a few years, to provide flexibility in employee transitions and to put the ownership of the RC facilities into broad retail participation.

(c) to identify the scope of RC facilities to be divested as some of the RC facilities which may likely be unsuitable for divestment, due to age, size, condition and other factors, with the remainder of the portfolio as such properties may have a negative valuation impact for the Divestment.

9. The Consultants have evaluated the various divestment options available and concluded that certain divestment options may not be able to meet the key objectives of the HA because of the existing regulatory framework, potential adverse impact on HD employees and on the physical property market, the long timeframe, or inability to achieve 100% divestment of those properties identified as suitable for disposal.

RECOMMENDED DIVESTMENT STRATEGY

10. Following a detailed evaluation of the various divestment options and taking into account all the key considerations and issues, the Consultants have recommended a combined disposal strategy for the Divestment. This combined strategy can be divided into two major components:

(a) IPO on the Stock Exchange of Hong Kong (the "Stock Exchange") of a property company (or a REIT[2]) owning the RC facilities ("ListCo") which has the following characteristics: (1) focused business strategy; (2) clear dividend policy, which pays out majority of the net earnings; (3) conservative gearing policy; and (4) restrictions on speculative developments. These characteristics are similar to those of a REIT such that ListCo will be clearly differentiated from property companies currently listed on the Stock Exchange; and

(b) optimisation of the RC Properties portfolio for the IPO option, which will require the disposal of certain properties outside of ListCo through tailored solutions

11. The recommended divestment strategy will provide an opportunity for investors' participation in the ownership of the RC facilities through the capital market, and minimizes the impact of the divestment on the local property market. The risk of disruption to existing tenants and services will be low, and HA staff will be provided with an opportunity to seek employment with ListCo in order to meet the track record requirements for the purpose of the IPO.

[2] REIT legislation is not currently in place. Please refer to Paragraph 21 for more details.

PROPOSED IPO STRUCTURE

12. The Consultants has designed a tailored structure for the HA to divest its RC facilities *(the "Proposed IPO Structure")* within 12 to 18 months, subject to the timing required for the restructuring of the RC facilities and creation of a divestment vehicle. This structure incorporates and combines the key features of a property company IPO, REIT and securitisation. This structure allows an IPO of the cash flows of the RC facilities on the Stock Exchange to be brought forward, while the legal ownership over the RC facilities will not be transferred until such time the procedures relating to title and future building control are completed. ListCo will make an initial payment to the HA as the consideration for the gross rental cash flows from the RC facilities being assigned to ListCo. As the RC facilities are made ready for private sector ownership and the legal titles are transferred to ListCo, the HA will receive final payment(s) from ListCo, subject to the timing and process of the RC facilities being transferred into ListCo.

IMPLICATIONS ON STAKEHOLDERS

The Government / Housing Authority

13. The Government / HA should be able to achieve their objective of a 100% divestment. However, the Divestment will have an impact on the future income for both the HA and the Government.

HD staff

14. To ensure a seamless transition for operations of the RC facilities, it will be in ListCo's commercial interests to recruit a good proportion of its employees from the HA. Some suitable employees outside of the HA may also be attracted to join ListCo. Certain staff who opt to remain with the HA can remain in the service to continue to have a career.

RC facilities tenants

15. Certain RC facilities tenants may initially be resistant to the Divestment as the new owner may adopt commercial principles in operating the RC facilities. Based on international precedents, early fears will subside quickly, once the tenants perceive that new management is adding value, leading to a rise in pedestrian flows, turnover and profits. It is important to emphasise to existing tenants that the initial focus of ListCo upon divestment will be the control of the bottom-line costs and not grow top-line revenue.

Service providers

16. The HA and ListCo will need to negotiate with the relevant service providers for a novation of the contracts to ListCo upon Divestment. The performance and compensation of service providers will be assessed based on private sector practices.

Public housing tenants and other users of the facilities

17. Public housing tenants and other users may be concerned at the prospect of any change to the facilities. However, changes in the use and area of the RC facilities will be limited under the government leases to be obtained, and ListCo can generate profits only by operating the RC facilities most suited to users' needs. The introduction of private sector practices is likely to have a positive impact on services through increased market responsiveness and operational flexibility.

OTHER CONSIDERATIONS

Phased divestment through multiple IPOs

18. The disadvantages of a phased divestment through IPOs of several property companies include:

(a) existing HA employees who are currently involved in the management of the RC facilities will not be able to transfer, if desired, to ListCo at the same time;

(b) operational efficiencies and economies of scale will not be achieved as each listed company will have different management and board of directors; and

(c) time and cost involved in multiple IPOs will likely be higher than a single IPO.

Portfolio optimisation

19. The HA intends to divest all the RC facilities. A preliminary analysis of the RC facilities conducted by the consultant indicates that certain properties may not be suitable for inclusion in the divestment portfolio. This will be subject to closer review based on detailed assessment of individual properties during the implementation phase.

Market conditions and window for divestment

20. Given the current historical low point of the interest rate cycle, there is a growing market demand for high-yielding products. Hence, conditions are ripe for a divestment through the listing of a high-yielding REIT-like structure as is envisaged for ListCo.

Hong Kong REIT regulations under consideration

21. The Securities and Futures Commission has recently released a consultation paper on the draft regulations for a Hong Kong REIT, and targeting the finalisation of the regulations in third quarter this year. As a result, REIT may be a feasible and available divestment option for the HA, subject to the requirements under the final REIT regulations. In this context, the HA should immediately proceed with the restructuring phase as such restructuring will be required regardless whether ListCo procures its listing through a property company with REIT-liked qualities or a REIT. At the same time, the HA should remain flexible as to the offering structure, be it a property company or a REIT, with any final decision having given due consideration to prevailing marketing conditions, and status of and requirements under the final REIT regulations.

Implementation Plan

22. The Consultants have devised an implementation proposal for the recommended divestment strategy which consists of the following three phases:

(a) **Preparatory Phase** - to be conducted internally by the HA in preparation for the restructuring and IPO processes

(b) **Restructuring Phase** - to be completed with the advice of financial, legal, accounting and other advisers with the aim to create ListCo

(c) **IPO Phase** - to be completed with the assistance of financial, legal, accounting and other advisers for the IPO of ListCo

23. The Restructuring Phase and the IPO Phase should be executed in parallel in order to maximise efficiency and synergies between the creation of ListCo and the IPO marketing efforts. It is expected that the new company will be set up and be listed on the Hong Kong Stock Exchange, tentatively in 2004/05.

POST-IPO ARRANGEMENTS

24. After the IPO, both the HA and ListCo will need to complete tasks remaining from the restructuring process, such as completing the procedures relating to title and future building control, transfer of the RC facilities into ListCo and resolution of the remaining properties, as well as for ListCo to fulfill its obligations as a listed company with the goal of maximising shareholder value, meeting the external reporting requirements and executing its business plan.