

## Legislative Council Panel on Housing

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

#### Purpose

This paper provides additional information as requested by Members on the divestment of the Housing Authority (HA)'s retail and car-parking (RC) facilities.

#### Background

2. We briefed Members on the progress of the divestment project at the Panel meeting held on 3 May 2004. The Administration was requested to -

- (a) provide a wish list of commercial tenants together with information on whether and when each of the wishes could be resolved / decided;
- (b) advise whether there is any policy to protect interest of small commercial tenants;
- (c) provide executive summaries of the consultancy reports relating to the divestment; and
- (d) advise how the board of directors for the new company to manage the Real Estate Investment Trust (REIT) will be formed for the first and successive terms.

#### *(a) Wish list of commercial tenants*

3. HA commenced consultation with its commercial tenants in July 2003, and has since met with various commercial tenant groups to listen to their concerns and exchange views on the divestment project. A list of these groups is at Annex A. HA has also briefed a number of District Councils at their request. The major concerns and suggestions collected from these channels are summarised at Annex B.

4. HA is seriously taking up the issues raised by the various parties with the new company (MgtCo), which has recently been established for managing the REIT. We expect that the Chief Executive Officer of MgtCo, who will formally assume duty in mid-July, and his senior management team will meet and discuss with the tenant groups over the next few months to consider their concerns. Before the public listing of the REIT, HA will continue to maintain a keen interest on the dialogue between MgtCo and the commercial tenants, and will facilitate the establishment of a partnership relationship between the two sides with a view to identifying win-win solutions to the issues raised.

***(b) Interest of small commercial tenants***

5. The question of small tenants' interest is an issue raised by some of the commercial tenant groups from time to time. Small tenants constitute a major proportion of the commercial tenants in the RC facilities to be divested. HA has impressed upon MgtCo the needs and special circumstances of small tenants. We believe that it would be in the interest of MgtCo to foster an open dialogue and close partnership with small tenants in its effort to enhance the asset value and operational efficiency of the RC facilities.

***(c) Executive summary of consultancy reports***

6. At Annex C is a summary of the consultancy report completed last year which recommended the broad strategy being adopted for the divestment project.

***(d) Formation of the Board of Directors***

7. The initial board of MgtCo will be appointed by HA, as MgtCo is a wholly-owned subsidiary of the HA before divestment. HA will ensure that the board's composition can bring in expertise and diverse talents (e.g. property development, fund / investment management, retailing) consistent with industry best practices.

8. After the divestment, all shares of MgtCo will be held by the trustee of the REIT and beneficially owned by unit holders of the REIT. The board of MgtCo will therefore be appointed by unitholders of the REIT. HA is working with its advisors to develop an appropriate corporate governance structure for MgtCo, taking into account industry best practices and the views of concerned parties including this Panel.

**List of commercial tenant groups**

- 全港公屋商戶總會 (HK Public Housing Estate Shop-operators Union)
- 公屋聯會 (The Federation of HK, Kln, and NT Public Housing Estates Resident and Shopowners Organizations)
- 香港零售管理協會 (Hong Kong Retail Management Association)
- 街市及商場 (私人承包) 商會有限公司 (Markets and Shopping Centres (Single Operator) Association Ltd)
- 香港停車場專業協會 (The Parking Association of Hong Kong)
- 香港醫學會 (Hong Kong Medical Association)
- 公共屋邨執業西醫協會 (Practising Estate Doctors' Association Ltd)
- 香港醫務委員會執照醫生協會 (The Association of Licentiates of Medical Council of Hong Kong)
- 香港西醫工會 (Hong Kong Doctors Union)
- 香港牙醫學會 (Hong Kong Dental Association Ltd)
- 屋邨牙醫小組 (Estate Dentists Group)

**Major Concerns and Suggestions raised by Commercial Tenants**

**1. Rental policy**

- 1.1 Rental increase by MgtCo for pursuit of higher profits?
- 1.2 Possibility of rent review on a three-year cycle, in accordance with Consumer Price Index (CPI) movements?

**2. Various tenancy terms**

- 2.1 Continue with the existing arrangement, including those for -
  - (a) air-conditioning charges;
  - (b) management fees (of which the rent is inclusive);
  - (c) rent deposit (ie generally two-months' rent, in cash and / or bank guarantee);
  - (d) exemption from stamp duty payment;
  - (e) area of letting being expressed in Internal Floor Area, instead of Gross Floor Area;
  - (f) negotiation mechanism on rental levels; and
  - (g) termination of tenancy?
- 2.2 As a comfort to sitting commercial tenants -
  - (a) Will they be eligible (or enjoy priority) for tenancy renewal? [Note : Some groups have asked for tenancy renewal up to 9 years.]
  - (b) Alternatively, will the tenancy period for these tenants be extended (say, to 5 years)?
  - (c) Will MgtCo be prohibited from exercising "early termination" provision against these tenants?

- 2.3 Any one-off and unconditional waiver for the so-called "conspired sub-letting"?
- 2.4 Any ex-gratia payment (and, for those let on premium tender, return of premium) to those opting to move out, or those with tenancies not renewed by MgtCo?
- 2.5 Insurance against damage to the premises (by fire and other perils such as typhoon and flood) continues to be provided at the cost of the landlord?
- 2.6 Arrangement for commercial tenants benefited from the 2001 Rent Assessment Exercise, bearing in mind that the lower rent assessed under the exercise will expire by end of October 2004?
- 2.7 Arrangement for rent relief measures such as "rent adjustment" for new estates with slow population intake?

### **3. Trade mix**

- 3.1 Continue with the existing trade mix to avoid unhealthy competition?
- 3.2 Prospect for MgtCo to minimise vacancy rate by compromising the original trade mix?

### **4. Interests of small tenants / social responsibility of MgtCo**

- 4.1 How to protect the interest of small tenants?
- 4.2 How to avoid monopoly / oligarchy of RC facilities by individual operators (especially those of big names)?
- 4.3 More fundamentally, how to avoid MgtCo being "taken over" by large corporations?
- 4.4 Given MgtCo's priority to financial returns, how to ensure its social responsibility (e.g. provision of healthcare services) and commitments to the tenants?
- 4.5 Will MgtCo sell off RC properties under its portfolio, as they have an incentive to do so in respect of those with low return rate?

4.6 Will HA retain a certain degree of control over the operation of MgtCo after divestment?

## **5. Maintenance / repair cost**

5.1 Will the MgtCo take up the cost of maintenance / repair services?

5.2 Will the MgtCo cut the budget for maintenance / repair services for these properties given their low return rate?

## **6. Communication channels with tenants**

6.1 Any channel for commercial tenants to monitor the transitional arrangement?

6.2 Any consultation / communication mechanism between the MgtCo management and the commercial tenants?

6.3 Any appeal mechanism on MgtCo's decision in future? Any mechanism to monitor its policy (e.g. rental policy) and operation?

6.4 Will commercial tenants be represented on MgtCo's board of directors?

## **7. Operational management**

7.1 Small tenants against a wider use of the single-operator system, but this is advocated by the existing "single operators".

7.2 Continue with the existing policy of out-sourcing carpark management to outside companies?

7.3 Ability for MgtCo to take up at once the management of a massive portfolio of RC facilities?

7.4 Will estate common areas and prohibited zones be clearly carved out to minimise potential management problems after divestment?

7.5 Important to ensure a smooth transfer of existing contracts or financial instruments (e.g. letter of guarantee) to MgtCo.

## **8. Others**

- 8.1 Given all the adverse implications of the divestment project on the commercial tenants, will HA defer / call off the project?
- 8.2 Provision of clinic services according to population ratio?
- 8.3 Possible to exclude clinics from divestment, having regard to their social service nature?
- 8.4 Possible for commercial tenants to subscribe for REIT units on a pre-emptive basis?
- 8.5 Possible for sitting tenants to buy their own shops?
- 8.6 Compensation arrangement for redevelopment?

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

## **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<sup>1</sup> was commissioned in July 2002 by the HA to assess the feasibility of the Divestment. In addition, the consultant has

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<sup>1</sup> 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<sup>2</sup>) 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.

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<sup>2</sup> 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.