

## **Legislative Council Panel on Housing**

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

#### **Purpose**

This paper briefs Members on the proposed divestment of the Housing Authority (HA)'s retail and car-parking (RC) facilities.

#### **Background**

2. On 18 July 2003, we informed the Legislative Council<sup>1</sup> that the Chief Executive in Council had approved our proposal to seek the HA's agreement in principle to divest its RC facilities, and that the net proceeds from the divestment in principle should entirely go to the HA to meet its budget deficit for the short term.

3. At its meeting on 24 July 2003, the HA agreed in principle to divest its RC facilities and approved, inter alia, the following –

- (a) a broad divestment strategy;
- (b) the appointment of Global Coordinator(s) (GC) and other necessary advisers and consultants assisting in the implementation of the project; and
- (c) the establishment of a Supervisory Group to monitor and steer the divestment project.

4. Details of the divestment project are set out in the paragraphs below.

#### **Reasons for divestment**

##### ***Withdrawal from commercial operation***

5. Divestment of the HA's RC facilities would enable the HA to focus its resources on its core function as a provider of subsidised public housing.

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<sup>1</sup> See relevant Legislative Council Brief issued on 18 July 2003.

Furthermore, it is likely that the RC facilities will generate better returns under the operation of the private sector, which will in turn have a positive impact on the overall economic development of Hong Kong.

### ***Tiding over budget deficit***

6. Following the announcement of Government's new housing policy in November 2002, the production and sale of Home Ownership Scheme (HOS) flats have ceased indefinitely and the sale of Tenant Purchase Scheme flats will be halted. In the absence of other replacement income sources to fund its capital expenditure on the production of public rental housing flats, the HA will incur an annual net cash flow deficit<sup>2</sup>. Proceeds from the proposed divestment will help to meet the 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.

### **Divestment strategy**

7. Having considered the pros and cons of the various divestment options available (e.g. outright sale and securitisation), the HA agreed to adopt the following broad strategy to take forward the divestment project –

- (a) a new company with characteristics of a 'Real Estate Investment Trust'<sup>3</sup> (REIT) will be set up<sup>4</sup>;
- (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. This company will then 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 titles 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: (i) a major proportion of the sale amount will be paid immediately after the IPO, and (ii) the balance will be paid upon the completion of transfer of legal titles.

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<sup>2</sup> We estimate that the HA will have a negative cash balance of \$5.5 billion by end of 2005/06.

<sup>3</sup> 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.

<sup>4</sup> Subject to the advice of GCs and other relevant factors, the HA may consider the alternative approach of establishing a REIT, instead of a company with REIT characteristics.

8. This divestment strategy has a number of merits, including, –
- (a) it will enable the HA to realise the divestment proceeds within a relatively short time frame;
  - (b) the REIT characteristics of the new company will attract valuation of the company close to its net asset value;
  - (c) it will provide an opportunity for investors' participation in the ownership of the RC facilities through the capital market, and minimise the impact of the divestment on the local property market; and
  - (d) the risk of disruption to existing tenants and services will be low, and the HA staff may be provided with an opportunity to seek employment with the new company.

### **Financial implications**

9. Based on some preliminary estimates, the net proceeds generated from the divestment of the RC facilities will be over \$20 billion<sup>5</sup>. The actual valuation will be conducted by the GCs in due course, 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 mentioned above, there will possibly be adjustments in the final valuation. Notwithstanding, the HA will 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.

10. Notwithstanding the pre-existing financial arrangements agreed between the Government and the HA<sup>6</sup>, the Government has agreed in principle to allow the HA to retain the full proceeds from the divestment to meet its cash flow deficit.

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<sup>5</sup> This has been worked out in accordance with normal market practice, using a discounted cash flow analysis over a 10-year period of the rental income from individual RC facilities to be divested and the residual value of the facilities thereafter.

<sup>6</sup> The current arrangement between the Government and the HA is that the value of land for 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.

## **Staff arrangements**

11. We estimate that about 700 civil service (including departmental and general grade positions) and HA contract posts ranging from professionals to front-line officers would be affected by the divestment project. It is likely that some of the existing staff will be required to support the new company during the initial stage, through, possibly, temporary secondment or service contracts. There may also be opportunities for staff to be recruited by the new company given their operational knowledge and experience, in order to meet the management track record requirements for the purpose of listing.

12. We have conducted a series of briefings for staff since the HA approved the divestment project in July 2003. We have also regularly kept the staff informed of developments through our in-house e-newsletter. Following the recent appointment of GCs, we will work out with them the staffing arrangements for the new company, including possible exit arrangements for existing staff concerned. We will involve staff in the process and will explore all possible means to facilitate those affected staff who wish to continue their career in the civil service.

## **Communication with stakeholders**

13. We arranged a number of briefings for various stakeholders (e.g. commercial tenants, service providers) in August 2003. The main concerns expressed by the stakeholders include rent increase, security of tenancy and continuity of letting/contracting policies. We also briefed a number of District Councils upon their request. Information leaflets on the divestment were distributed to tenants and other interested parties, who were invited to give their views and suggestions to us. We have agreed with the stakeholders that we will reflect their concerns to the GCs and regularly keep them posted of developments. It is expected that we will brief them again in late 2003/early 2004 when we have a more detailed implementation plan.

## **Scope of RC facilities to be divested**

14. Although the HA aims to achieve a 100% divestment of its RC facilities, a preliminary appraisal indicates that a small proportion of the RC facilities may not be suitable for the purpose because of their poor location, small scale and old/obsolescent conditions. Their inclusion will likely lower the perception of the overall asset quality and adversely affect the valuation of the RC portfolio. In this connection, we will undertake a critical review of all the RC properties in consultation with the GCs and will formulate our recommendations for the consideration of HA.

### **Statutory requirements for the RC facilities**

15. At present, all HA and Government properties are exempted from regulatory control under the Buildings Ordinance (Cap. 123). For the purpose of the divestment, we are conducting thorough site examination of the RC facilities and compiling the required plans and records to facilitate future building control.

### **Transfer of legal titles**

16. We have started work on preparation and modification of leases and Deeds of Mutual Covenant (DMCs) for the RC properties to be divested. Given the considerable number of estates involved and the complicated procedures which we need to go through for preparing the leases and DMCs, it is expected that the transfer of legal titles from HA to the new company will be completed by end 2006.

### **Establishment of an HA Supervisory Group on Divestment**

17. For a project of such a magnitude and importance, close monitor and steer from the HA are necessary. As the divestment project involves cross-cutting issues related to commercial properties, finance and human resources management, the HA has set up a dedicated Supervisory Group on Divestment to monitor progress and provide advice and guidance on the implementation of the project.

### **Way forward**

18. The most imminent task for us is to work closely with the GCs to hammer out a restructuring plan for the RC properties. Subject to the time required for the restructuring, the creation of a divestment vehicle and the prevailing market conditions, our current plan is to list the new company on the Hong Kong Stock Exchange, tentatively, in 2004/05. A brief indicative timetable is at the Annex.

**Tentative Timetable on Divestment of HA's RC Facilities**

- Appointment of GCs & advisers to assist in the restructuring, setting up the new company and preparing for the IPO October 2003
- Establishment of the new company 1st - 2nd quarter of 2004
- Taking over the management of RC facilities by the new company 2nd - 3rd quarter of 2004
- IPO of the new company Before end of 2004/05
- Completion of the transfer of legal titles End of 2006