

## Conduit controversy

12th July 2010

We must admit to being tempted to let [Henderson Land Development Ltd \(HLD, 0012\)](#) stew in its own juices and let the populist politicians flay them over the [39 Conduit Road](#) project. So we did for a bit, but now it's time for Webb-site to intervene. The Government's [Lands Department](#) and even [the police](#) have got in on the story - for a change the Government seems keen to be seen acting tough against a developer, after all the past allegations of collusion with Hong Kong's feudal property lords who dominate the domestic economy in so many sectors.

However, for once, we find ourselves rising to the defence.

### Background & history

The patch of land at 39 Conduit Road is formally "Section A and the Remaining Portion of Inland Lot No. 7898", on a government lease granted for 75 years from 20-Nov-1911 (trivia: the day of the world premiere of Gustav Mahler's "The Song of The Earth") with a right of renewal for one further period of 75 years. So the remaining lease runs for 51 years to 2061. Part of the site once held a 44-unit apartment block called Rockymount, completed in Mar-1964. Before that, there was probably a mansion.

The site (before the current sale) is 60.75% owned by Carry Express Investment Ltd (HK, **Carry Express**) and 39.25% by Nation Sheen Ltd (HK, **Nation Sheen**). Carry Express was incorporated in 1960 (then known as Tyson Investments Ltd) and was the original developer of Rockymount, whereas Nation Sheen was a relative newcomer, incorporated in 1999. The Agreement and Conditions of Exchange signed by Carry Express relating to the previous development was dated 20-Aug-1962.

Some light is shed on the site's history by a [court action](#) in which Elton Chow Sing Yuet, an architect, is suing Carry Express for fees arising from a 1991 contract. Between 1988 and 1991, Carry Express had accumulated 22 of the 44 units in Rockymount but was having difficulty persuading owners to sell the rest. Carry Express had also acquired the land at the rear of Rockymount, known as the "Remaining Portion" of the lot. Carry Express told the court that in an attempt to scare out the remaining owners, it pretended to plan development of a building on the Remaining Portion, hoping that this would persuade the Rockymount owners to sell before the development in their back yard started, and that the architect had been engaged as part of that pretence. The architect did not sue until 2007, and the judgement of a preliminary issue notes that the main trial is due to commence in July 2010 (this month).

HLD [bought](#) its 60% interest in the project in a connected transaction on 6-Jun-2008 from the family trust of Lee Shau Kee, HLD's Chairman and controlling shareholder, when the building's superstructure had already been completed. Carry Express was 100% owned by Washington Engineering Ltd (HK, **Washington**), while Nation Sheen was indirectly 100% owned by Cityline Venture Ltd (BVI, **Cityline**). Washington and Cityline were each 30% owned by Furnline Ltd (BVI, **Furnline**) and Perfect Bright Properties Inc. (BVI, **Perfect Bright**), both of which were "controlled" by the trust, if not 100% owned. The reason the trust used two different holding companies with equal shareholdings is unknown to us, but perhaps the trust earmarks one for each of the Chairman's sons. Probably because of sloppy tax-planning, Furnline and Perfect Bright had other assets besides their stakes in Washington and Cityline, and we suspect that these could not easily be moved out before the sale. So instead, HLD acquired all the "B Shares" in each of Furnline and Bright Properties, and these shares carry all the economic interests in the "B Assets", namely the shares in Washington and Cityline.

So, through the B-shares of Furnline and Perfect Bright, HLD has a 60% interest in the project. All the media attention has been on HLD, but it is not the only owner of the project. 32% of Washington and Cityline are owned by Yeung Sai Hong (**Mr Yeung**) who has other joint developments with HLD. The remaining 8% is owned by the Executors of an estate, presumably of a dead person, although s/he was not named.

Mr Yeung is apparently something of a deal-maker. On 30-Sep-2005, he and Yeung Kwok Sang [sold](#) a 70% interest in a company which had assembled all but one apartment (11 out of 12) in a redevelopment site then known as Villa Splendor, at 9-12 Chun Fai Terrace, Tai Hang, HK Island, to [New World Development Co Ltd \(NWD, 0017\)](#). The auction reserve pricing of the compulsory purchase of the remaining unit is something that we will write about another time, because it highlights the inequities of the building approvals system in HK.

Mr Yeung is a director of privately-held [Peterson Holdings Co Ltd](#), known until 1994 as "Peterson Embroidery Co Ltd", which suggests that the family money came from the textile industry. Nowadays, they are mainly in property and hotels. Previous residential joint ventures with HLD include Metropolitan Rise at 28 Ma Tau Kok Road, Kowloon (completed in 2001, 80% HLD) and Splendid Place at 39 Taikoo Shing Road, HK Island (75%

HLD, 2004). Another joint venture with NWD was Bon Point at 11 Bonham Road, HK Island (2004, 70% NWD).

## Tax

The announcement of HLD's buy-in to the venture in 2008 stated that of the two subsidiaries, Carry Express intended to hold its 60.75% of the finished units (allocated by value) for "long term investment purposes", while Nation Sheen intended to sell its 39.25% share of the finished units. We note that in the [Jun-2009 interim report](#), HLD said that 40 of the 66 residential units were "for investment purpose", very close to the 60.75% figure. However, it appears to have later changed its mind, saying in the [Dec-2009 annual report](#) (p13-14) that only 17 units are for investment purpose. So it appears that both companies are marketing their units for sale. Perhaps Carry Express will try to claim that its sales were capital assets and hence generated capital gains, which are tax-free, rather than taxable profits.

This would not be unprecedented - indeed, a company owned by Mr Yeung, Weson Investment Ltd, successfully appealed a tax claim in a similar case. In 1993, Weson purchased a parcel of land in Tsuen Wan District, New Territories, and in early 1995 it subdivided the land into two for the purpose of building a service station on one part. It sold the redeveloped part which sale completed in Jun-1996. Eventually in Dec-1999 the Inland Revenue assessed the profit for tax. Weson appealed this in 2002, and the Board of Review granted the appeal in 2003. Tax appeals are usually private, but this [came to light](#) because Weson then unsuccessfully sued for interest on the tax it had paid in Aug-2000. The court ruled that if Weson wanted interest, then it should have purchased interest-bearing Tax Reserve Certificates instead.

## Numbering scheme

39 Conduit Road has already earned itself a place in history by the controversy surrounding the somewhat unusual numbering scheme for its floors. [We saw this](#) as a harmless (and unoriginal) marketing gimmick - it was plain to anyone who looked at the brochure or web site that the 88th floor was in fact the 33rd residential storey and is 40 storeys above the Ground Floor (there are 6 levels of car park and club house, and one refuge floor), albeit that a few of the top floors are double-height. But the politicians climbed onto a convenient bandwagon and as a result, "among the relevant stakeholders, [a consensus was reached](#)" that for future projects, floor numbers should be in "a logical and consecutive numerical series". However to "strike a balance" between logic and irrationality, floor numbers 4, 13 and those ending in 4 (but not the forties, except 44) can be omitted. The result is [Buildings Department ADV-3](#). Never let it be said that HK is not quadrophobic, triskaidekaphobic and octophilic. It is a small wonder that the Government didn't call in fung shui expert [Tony Chan Chun Chuen](#) to bless the scheme.

Of course, the omission of some floors on an optional basis blows a hole in the argument that the new system somehow corrects a purported safety issue for the emergency services, who would have no way of knowing whether the omissions have been made without looking at the lift lobby. Any fire above the 3rd floor may be on a different level to its floor number. So this was an example of unnecessary official meddling in a rather silly scheme to assuage public sentiment.

## The current controversy

On 13-Oct-2009, HLD launched 39 Conduit Road for sale, with a [price list](#) which grabbed headlines - the split-level "semi-duplex" [apartment A on the 66th floor \(38th storey\)](#) was priced at HK\$63,472 (US\$8,137) per gross sq ft. The next day, it was [disclosed](#) to the media that [apartment A on the 68th floor \(39th storey\)](#), which was not on the list, had been sold for \$71,280/gsf, a record for HK. Your editor David Webb was correctly quoted in the SCMP as saying "how ridiculous! I wonder whether the buyer will complete" the deal.

A note on floor areas: for readers outside HK, "gross floor area" (**GFA**) includes an apartment's share of all common areas such as lift lobbies and club house, whereas "saleable area" includes the area bounded by the outside of the external walls, the middle of any shared walls, and any balconies and utility platforms (but not bay windows). As a rule of thumb, saleable area in modern projects is about 75% of GFA, but your mileage may vary. Also, what matters to most people is the internal area, which is even smaller than the saleable area, because you cannot live in walls. Smaller apartments have even lower efficiency because the walls don't get thinner. For example, imagine an apartment with a gross floor area of 800 sq ft and a saleable area of 600 sq ft, which is a 20 ft x 30 ft box with 1-foot thick external walls. The internal area will be 18 ft x 28 ft, or 504 sq ft. That's 63% of GFA, with 12% in the external walls.

Eventually 25 units at 39 Conduit Road were contracted for sale, of which 1 completed by year-end. After granting extensions of time, on 15-Jun-2010, HLD [announced](#) that 4 of the other 24 sales, units A & B on 30th and 31st Floors (26-27th storeys) had been completed, and that the remaining 20 had been cancelled at the request of the buyers, with 5% of the purchase price forfeited and the rest of the deposit returned. HLD would record a loss on cancellation of HK\$734m, reversing part of last year's profit when the sales were booked. In the 18 months (due to a change of year-end) to 31-Dec-2009, HLD made HK\$14.32bn.

This is certainly a material amount, but the risk of such a reversal, and the amount involved, was flagged in the [results statement](#) on 30-Mar-2010, on pages 4 and 51:

"Turnover for the eighteen months ended 31 December 2009 included an amount of HK\$3,280 million relating to the sale of 25 units at 39 Conduit Road. At the recent requests of the buyers, the completion dates of the sale of 24 units have been extended by two to four months from February 2010. The turnover and profit after taxation arising from these 24 units attributable to the Group for the eighteen months ended 31 December 2009 amounted to HK\$1,912 million and HK\$973 million respectively. Currently, there are no reasons to believe that the sale of such 24 units would not proceed.

However, in the event that the sale of such 24 units is not completed, and before taking into account any re-sale of such units, the Group shall recognise an attributable loss of approximately HK\$780 million after forfeiture of deposits."

Although it was the two "68th Floor" units that grabbed headlines, if you look closely, as we have, you will see that the average price of the 22 normal-unit sales was \$34,731/gsf, ranging from \$24,250/gsf to \$42,000/gsf. That average is still a mind-numbing price beyond the reach of most people, and way out on the right-hand tail of the bell curve, but not beyond the realms of possibility. At that layer of the stratosphere, HLD was probably commercially willing to allow people to buy "call options" through shell companies, by putting down deposits in the expectation of broking them to ultra-high net worth mainlanders or others, either as end-users or as investors. It is fairly clear from the transaction records that there were several groups of multiple units involved, with different representatives and addresses (see below).

The great irony of the current Government investigations is that failed speculative transactions are exactly what they should expect if the [cooling measures announced](#) in the budget on 24-Feb-2010 and the [reduction](#) in mortgage loan-to-value ratios were having an effect - so which do they want - cooling measures or an escalation of the bubble? They seem to be complaining that speculative deals have failed rather than celebrating that their measures might be having some mild impact. It is also clear that mainland measures to cool their property market and rein in credit are also likely to impact on the HK property market, having contributed to the excesses alongside low interest rates imported from the US.

## Corporate buyers

All transactions in HK are reported to the Land Registry, so even if HLD had not disclosed the price and the registered buyers' names, it would have been public knowledge soon afterwards. Any criticism that HLD made hay out of the transaction news should be tempered by the fact that it would have hit the headlines anyway, as the estate agencies all monitor transaction records. The agreements are also filed and open to public inspection, so it was quickly evident that the buyers were newly-formed HK shell companies.

For various reasons, many buyers of properties, new or second-hand, choose to use a dedicated company which has no other assets (often called a shell company) to buy and hold the property. These reasons include:

- Avoiding disclosure of the ultimate owner's name - using an offshore company where there is no public share register. This is particularly important if you are a mainlander who is bypassing the PRC's capital controls, or if you want to hide assets from your spouse, or if you can't account for so much money in the first place or are a public figure (or both).
- Allowing the ownership to be transferred in future by selling the company rather than the property. If the company is offshore, then there is no stamp duty to pay, whereas properties attract stamp duty of up to 4.25% on every transfer. We called for abolition of stamp duty in our article [HK's stamp duty addition](#), 2-Mar-2010.
- Allowing children who jointly inherit a property to buy each other's shares in the property by buying shares in the company, without paying stamp stamp duty
- Allowing the property to be resold even before the company has completed the purchase - the company is, in effect, a call warrant on the property, giving the holder the option to pay the completion money to buy the flat, or to walk away and forfeit the deposit. This is particularly useful if the apartment is sold off plan (a "pre-sale") with a long time until it will be delivered and paid for.
- Avoiding possible assessment for profits tax if the owner is someone who regularly flips apartments - the Inland Revenue has in the past taxed people even with just a few transactions on the grounds that they are running a business of "trading" in properties, but the IRD is never going to know if an offshore company changes hands, and the deal can even be struck outside HK.
- Renting the property to the owner of the company in order to take advantage of the "tax benefits" loophole, whereby the Inland Revenue deems the value of housing provided by an employer as worth only 10% of his cash income. This is worthwhile if the property-owning company does not make taxable

profits - for example, it can offset the interest on a mortgage it used to purchase the property. So a salary of \$50,000 with a housing benefit of \$50,000 is only worth \$55,000 for Salaries Tax purposes. We have [called in the past](#) for this loophole to be closed.

Given the above incentives and the size of the transactions, there is nothing unusual in the fact that the buyers in Conduit Road were all companies. Each unit was contracted by a HK company, and each HK company was held and directed by a different offshore company. In the cancellation agreements filed with LegCo, the 24 HK companies have registered offices in three different places. 9 were at unit 701, 7th Floor, World-Wide House, which is the office of Lo and Lo, the solicitors to HLD. There is nothing unusual about a firm of solicitors acting for both sides in new property transactions in HK, despite the obvious conflicts of interest. So it wouldn't surprise us if part of the service included setting up companies for the buyer. Another 8 buyers (including 4 who completed) were registered at 10/F, Cosco Tower. That is also the address of financial services firm [Get Nice Holdings Ltd](#) (0064). Perhaps they introduced some clients to the property. The other 7 buyers were registered to 18/F, China Hong Kong Tower. From our desktop we cannot find who the tenant there is.

## Sale and purchase agreement

Questions have been asked by legislators about the nature of the sale and purchase agreement (SPA) used in these transactions. The Civic Party's Ronny Tong Ka Wah [called](#) the agreement "abnormal" and accused HLD of showing "incomprehensible business logic" in returning the balance of the deposits to the shell companies. The Democratic Party's Lee Wing Tat [asked](#) why HLD had not pursued the purchasers for \$1bn in damages.

Well, first of all, the SPA is a standard form contract which is actually specified by Government regulations - the template is in [Legal Advisory and Conveyancing Office \(LACO\) Circular Memorandum No. 60](#). This standard agreement is part of the [pre-sale Consent Scheme](#) for uncompleted projects. Clause 11(3), which was used in this case, says:

"(3) In the event of the Purchaser requesting and the Vendor agreeing to execute a Cancellation Agreement or any other means which has the effect of cancelling this Agreement or the obligations of the Purchaser hereunder, the Vendor shall be entitled to retain the sum of **5% of the total purchase price** of the Property **as consideration for his agreeing to cancel this Agreement and not as a penalty** and the Purchaser will in addition pay or reimburse, as the case may be, to the Vendor all legal costs, charges, disbursements (including stamp duty, if any) in connection with the cancellation of this Agreement."

Now, of course in theory (absent regulation) the parties to any legal agreement can, after the agreement, agree to cancel it on whatever terms they like. The fact that the Government-approved standard contract specifies one such method of cancellation just provides some hope for purchasers that they might, if the vendor agrees, be able to get out of it. If that method is used, then the purchaser forfeits 5% and gets the rest back. But legislators and the Government are asking why HLD did not use another clause in the standard agreement, clause 16 which says:

"(1) Should the Purchaser fail...to make the payments in accordance with Schedule 5...within 7 days of the due date, the Vendor may (subject to Clause 3(3)) give to the Purchaser notice in writing calling upon the Purchaser to make good his default. In the event of the Purchaser failing within 21 days from the date of service of such notice fully to make good his default, the Vendor may by a further notice in writing forthwith determine this Agreement.

(2) Upon the determination of this Agreement pursuant to sub-clause (1) :-

(a) the sum paid by the Purchaser under **item (i) of Schedule 5** by way only of deposit shall be forfeited to the Vendor; and;

...

(3) Upon determination of this Agreement under sub-clause (1) the Vendor may resell the Property either by public auction or private contract subject to such stipulations as the Vendor may think fit and any increase in price on a resale shall belong to the Vendor. On a resale, any deficiency in price shall be made good and all expenses attending such resale shall be borne by the Purchaser and such deficiency and expenses shall be recoverable by the Vendor as and for liquidated damages Provided That the Purchaser shall not be called upon to bear such deficiency or expenses unless the Property is resold within 6 months of the determination of this Agreement."

and item (i) of Schedule 5 says:

(i) the amount of \$[BLANK] has been **paid as deposit on signing of the agreement preliminary to this Agreement**;

This refers to the 5% deposit paid upon signing the Provisional Sale and Purchase Agreement, not to the amount of any subsequent payments. A second payment of 5% is usually made on signing of the formal SPA. In the Conduit Road case, HLD held a total of 10% deposits on 22 normal units and 15% on the "68th Floor" special units. So if HLD had used Clause 16, then it could only have forfeited 5%. There is a reason why the vendor cannot confiscate everything, a point of law which any legislator ought to understand: only the courts can order penalties. That is why Clause 11 speaks of the 5% as "consideration for agreeing to cancel... and not as a penalty". In clause 16, for the vendor to claim any more than 5%, it has to show a loss, by reselling the property within a reasonable timeframe (6 months, in this case) at a fair but lower price.

Could HLD have withheld the balance of the deposits for 6 months while it tried to make such a resale? Well, it could have tried, but in our view it had no legal basis for doing so - the standard contract does not provide for that. Simply having a potential claim against someone does not in itself entitle you to hold on to their cash. The Government could amend the standard contract to require this, but we doubt that politicians would be keen on including such a clause if they think about it - imagine if a person has paid not 10% but 30% of a purchase price, and then he loses his job and is unable to get a mortgage to complete the purchase. Would it be OK for the developer to hang on to the purchaser's cash for 6 months? Be careful what you wish for, legislators.

After 19 years in HK, we've seen several market cycles, and it is not unusual for buyers to default on purchases and walk away from deposits. There were many such cases after the 1997 crash. At least in the individual (human) buyer space, developers are not keen to make their reputation worse by suing defaulting purchasers for the deficiency on resale, pushing the original buyer into bankruptcy. Behaviour like that doesn't tend to build customer or brand loyalty.

Furthermore, if HLD could not sell for at least 90% of the original prices within 6 months (or 85% for the 68/F), then it would still be out of pocket even if it had successfully claimed (or reclaimed) all the deposits. The buyers are shell companies, so they would not be able to pay any more than that, and there would be no point in suing them. Given a cooler market, HLD might reasonably have taken the view that it would rather hold on to the properties for now than sell them at more than 10-15% below the previous transaction prices. It might also take the view that it needs to maintain goodwill amongst speculators and middlemen if it is going to land the big fish in future in such a rarified market.

In the absence of any evidence of any connections between the buyers and the vendor, and with written statements from HLD to the contrary, we see no reason to doubt that these transactions were just plain old-fashioned speculation in the midst of a bubble.

### Were the prices "misleading"?

What has probably grabbed the most publicity is not that 20 deals have defaulted, but that the sale prices were so high in the first place, a symptom of the current bubble. This touches on the frustration of not just the one third of the population that lives in public housing and another sixth who live in subsidised housing, but also the middle classes who face a lifetime of paying off mortgages to finance a piece of air enclosed by a small concrete box purchased from one of HK's feudal landlords who then pay royalties to the SAR crown in the form of land premiums, taking a big fat cut in the middle and gaming the system as much as they can. They are a clique without whose support, through the Election Committee, the Chief Executive cannot be elected, and without whose support, through the functional constituencies, the Government cannot govern.

Issues like the Conduit Road numbering controversy and cancellations then become a proxy whip with which to thrash the developers, whether it is deserved or not.

The market for units in one building, particularly one with only 26 units initially available for sale, is not a deep, liquid market where transacted prices might be a close approximation to realisable value most of the time, like say, the share price of HSBC. That building is not the only building in Conduit Road, and Conduit Road is not the only road in Mid-levels. The units in a single building are what we call a "micro-market". Such markets are highly illiquid, and buyers need to do their homework and decide what an asset is worth to them before buying an asset. The same applies to small-cap stocks, rare postage stamps, art, coins, gems, vintage cars, wines and so on. At least with properties you can look at the rental yield.

Secondly, the prices reported and recorded at the land registry only represented agreements to buy, not completed purchases. Many commentators, including your editor, were rightly sceptical about whether the transactions would complete. If third parties in the property market are putting any reliance on other people's transactions at all, then they should be looking at completed purchases, which are filed with the Land Registry as "assignments" or delivery of the units. Even then, we would caution against such reliance.

So in summary, like most people, we found the agreed prices on the "68th Floor" ridiculous, and the other, less-publicised prices for lower floors merely silly, but we seriously doubt that any but the most ignorant

buyers saw the prices as a guide to what they should pay for a property elsewhere in Conduit Road or mid-levels, and we have no sympathy for anyone who thought that uncompleted transactions in a small project are a guide to the general market. These transactions are a symptom of a speculative bubble, not the cause of it.

As we said in our article on the soon-to-be-launched [Larvotto](#) (3-Mar-2010), HK is in one of its frequent property bubbles. On 18-May-2010, HLD Chairman Lee Shau Kee's family [paid](#) HK\$1.82bn (US\$233m) for a site at 35 Barker Road in a [rare public auction](#) of a private site. The property allows a GFA of 26,675 sq ft, and they will also pay to demolish the existing block of flats (called Falconridge) and build 3-4 houses for the billionaire's family compound. So the land alone cost \$68,229/gsf. The vendor was another tycoon, the low profile billionaire shipping-cum-property tycoon [Hui Sai Fun](#). He owns Central Development Ltd, which owns Central Building and Central Tower, in Central, and developed the [Highcliff](#) skyscraper at 41D Stubbs Road, which [really does](#) have 72 storeys above ground.

## Improving transparency

**One thing the Government could and should do, is to open the doors to free [online inspection of the Land Registry](#)**, so that people can see for themselves, with a few clicks, whether a transaction involves a company or individual and whether it has completed. Currently, every document involves a cumbersome and expensive pay-per-view procedure. The public interest would be better served by removing that barrier. The Land Registry's latest [annual report](#), for the year to 31-Mar-2009, shows (note 3, p158) that only \$73m of its \$426m in turnover came from search fees, while \$224m came from registration of documents. So it wouldn't cost much to shift that burden entirely to filing fees, and they don't even need to do that, because this government agency booked a profit of \$107m (before the tax it pays to its parent). So they could simply eliminate inspection fees and adopt a "sunshine policy" for public access.

Likewise, the HK Companies Registry's [online search](#) is also way behind best practice - you can check the name and incorporation date, but anything else, include details of directors and registered office, copies of annual returns and other filings, is pay-per-view. It should be free to inspect, and remain funded by filing fees.

## Market manipulation

While we are on the subject of unreasonable expectations from reliance on market data, we take a look at the Government and SFC's approach to this in today's [Manipulation mania](#) article, which also looks at shill bidding in auctions generally.

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