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Panel on Economic Development
Meeting on 17 January 2012

Background brief on Hong Kong Disneyland

Purpose

This paper provides background information on the Hong Kong Disneyland ("HKD") project, its operation since opening in 2005 and the expansion plan. It also summarizes major concerns and views of Members on related issues.

Background

Development of HKD

2. In December 1999, the Government entered into an agreement with The Walt Disney Company ("WD") to build HKD (Phase 1) at Penny's Bay[1]. A joint venture company, the Hongkong International Theme Parks Limited ("HKITP"), was set up for this purpose[2]. The then estimated total project cost of developing HKD Phase 1 was $14.1 billion, in addition to an estimated cost of $4 billion for reclaiming the land for Phase 1 of the project. The Government and WD had entered into five main agreements covering management, licensing of intellectual property, rights and obligations of shareholders, loan arrangements as well as the parties' responsibilities and undertakings for the development of HKD. The related financial and staffing proposals were considered by the former Panel on Economic

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1 The agreement anticipates a Phase 2 project, which will include a second Disney theme park, additional hotels and an expansion of the retail, dining and entertainment complex. Accordingly, the Hongkong International Theme Parks Limited is given an Option to buy the site immediately to the east of the Phase 1 Site for development of the second phase.

2 Under the agreement, the Government owns 57% of the shares in HKITP while WD owns 43%. HKITP operates under the supervision of a Board of Directors, which comprises five Government directors, four Disney directors and two independent non-executive directors.

Services[3] at the meetings on 11 and 15 November 1999, and endorsed by the Public Works Subcommittee and approved by the Finance Committee ("FC") on 17 and 26 November 1999 respectively.

Expansion plan

3. To realize the benefits of the long-term investment in HKD, the Government and WD reached agreement in July 2009 for the expansion plan. Under the relevant financial arrangements, WD would contribute all the necessary new capital as equity for the construction of the new attractions as well as sustaining the park's operation during the construction years, and convert the entire outstanding balance of the WD loan (i.e. $2.76 billion) to equity. Although the Government would not inject any new capital for the expansion, it would convert its loan to equity after retaining a balance of not less than $1 billion. Upon the capital injection by WD and conversion of the Government and WD loans, the Government would continue to be a majority shareholder of HKITP with ownership of about 52%[4]. The financial arrangements for the expansion of HKD were approved by FC at the meeting on 10 July 2009.

4. Pursuant to the expansion plan agreement, the formula for calculating the base management fee[5] has been revised for it to link to HKITP's performance, i.e. to replace the current formula of 2% of gross revenue by 6.5% of earnings before interest, tax, depreciation and amortization ("EBITDA"). A mechanism has also been put in place such that payment of royalties to WD's related company/licensor by HKITP will be deferred in the event that HKD's financial performance is hampered by adversity. WD has also agreed to make annual disclosure of the main operating and financial results of HKD for both the current and the immediately prior financial years. A list of indicators to be disclosed is in the **Appendix**.

5. The expansion proposal comprised three new themed areas[6], with more than 30 new attractions, bringing the total number of attractions in HKD to over 100. Works on the expansion project have already commenced and the first new themed area, Toy Story Land, has opened since

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[3] The Panel on Economic Services has been renamed as the Panel on Economic Development with effect from the 2007-2008 session.

[4] The Government's shares in HKITP will be lowered from 57% to 52% under the expansion plan.

[5] The agreement reached between Government and WD in 1999 also provided for a variable management fee with the rate of 2-8% of EBITDA. Under the new arrangement, the rate will be revised to 0-8% of EBITDA.

[6] The Government and WD agreed that two of the new themed areas, i.e. "Grizzly Gulch" and "Mystic Point", would be exclusive amongst Disney theme parks worldwide and the remaining one, i.e. "Toy Story Land", would be exclusive amongst Disney theme parks within the Asian region for five years after their respective openings.

November 2011. The remaining two new themed areas are scheduled to be completed in phases in 2012 and 2013 respectively.

Operating and financial performance

6. According to the Administration's assessment made in 1999, HKD would generate huge economic benefits for the Hong Kong economy, estimated to reach $148 billion over 40 years[7]. Below are the accumulated number of visitors received by HKD since its opening on 12 September 2005:

Year[8]	**Accumulated number of attendance**
2005-2006	5.2 million
2006-2007	9.2 million
2007-2008 (as at end of November 2008)	14.5 million
2008-2009 (as at end of December 2009)	19 million
2009-2010 (as at end of December 2010)	25 million

The two hotels at HKD recorded a combined occupancy rate of 82% in 2009-2010, representing an increase of 12% from 2008-2009.

7. To support HKITP, WD has waived the management fees and deferred payment of royalties for two years (i.e. 2007-2008 and 2008-2009). As at the end of 2007, HKD has also negotiated with commercial lenders to re-schedule its commercial term loan facility and the revolving credit facility with a view to reducing interest expenses. In September 2008, an agreement was reached between the Government and WD, under which the latter loaned $3.26 billion (consisting of a term loan and revolving credit facility) to HKITP. The loan was used mainly to repay the HKITP's commercial loan.

8. As regards financial performance in 2009-2010, HKD generated $3.013 billion of revenue which was about 19% higher than the previous year.

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7 The economic benefits of $148 billion over 40 years were calculated on the "base case" scenario developed in 1999. Under the "base case" scenario, it was estimated that HKD would attract an attendance of 5.2 million in its first year of operation and such attendance would rise steadily thereafter to 5.47 million in 2006 and 10.57 million in 2044. At the meeting of the former Panel on Economic Services on 29 July 2002, members were informed that WD considered the base case forecast conducted in 1999 too conservative and had therefore revised the attendance figure for the first year upward to 5.6 million.

8 Each year of operation of HKD starts in October and ends in the next September unless specified.

The EBITDA was $221 million, an improvement of $291 million from a loss of $70 million in 2008-2009. Net finance costs decreased by 73% from $387 million to $106 million due to the conversion of loans from shareholders to ordinary shares. This resulted in a $597 million improvement in net loss from $1.315 billion to $718 million. With the conversion of part of the loan from Government to ordinary shares and the capital injection from WD, which was partially offset by current year's net loss, shareholders' equity increased from $9.442 billion to $9.75 billion in 2009-2010.

Economic benefits

9. According to the survey statistics from Hong Kong Tourism Board ("HKTB") and the operational data of HKD, the additional spending of all HKD visitors in Hong Kong surged from $7.2 billion in 2008-2009 to $9.6 billion in 2009-2010. HKD brought about $5.6 billion of direct and indirect value added to Hong Kong in 2009-2010, equivalent to 0.3% of the Gross Domestic Product ("GDP"), and created 19 000 jobs (in terms of man-year). As of January 2011, the total value added generated by HKD since opening amounted to $19.6 billion or 0.2% of GDP. A total of 67 000 jobs (in terms of man-year) had been created in the period mainly for grassroot workers and the travel industry.

Staffing

10. In 2009-2010, HKD's full time workforce was approximately 4 300. It also engaged 1 400 part-time staff to cope with the increased demand at Halloween, Christmas, Chinese New Year, summer holidays as well as other special occasions. Since opening, HKD had employed more than 300 disabled staff members.

Concerns expressed by Members in previous discussions

11. Since the opening of HKD in September 2005, Members have raised a number of questions at Council meetings on issues related to the operation and performance of the park, public transport services for visitors, employment matters, financial and governance arrangements as well as injection of funds into HKD. The Panel on Economic Development ("the Panel") has also deliberated on related issues when the Administration reported on the operation of HKD each year. In 2009, the Panel held a series of meetings to examine the HKD expansion project before the proposal was submitted to FC for approval. The views and concerns expressed by Members at the relevant meetings are summarized in the ensuing paragraphs.

Park attendance and marketing strategy

12. Some Panel members expressed concern that the patronage to the park had fallen short of the base case scenario projected in 1999, and they urged the park management to step up promotional and marketing efforts to boost attendance. In particular, members highlighted the need to draw up a comprehensive business plan to tie in with the expansion project. They noted that the number of complimentary tickets given out by HKD each year for use during low seasons accounted for about 1% to 2% of total tickets. HKD was requested to present the attendance figures in respect of complimentary tickets separately from regular admissions in future updates.

13. Some Panel members suggested that HKD should incorporate more local cultural elements to suit the taste of the local public in order to stabilize the local source market, and direct more marketing efforts and resources to expand the Mainland market, in particular in view that there was a drop in the share of international visitors in the total attendance. HKD was also urged to consider partnering with the Ocean Park, Asia World Expo and other scenic spots in offering city pass for visitors, and collaborate with the travel trade in the Mainland and other source markets in Asia in promoting the park and the two hotels to tourists visiting Hong Kong.

14. To attract more visitors to HKD, some Members considered it important to enhance the accessibility of the theme park through the provision of different transport facilities, such as making better use of the pier near HKD. The Government was also urged to put the land adjacent to HKD to more gainful use, with a view to enhancing synergies with HKD and boosting patronage to the park. In view of the competition from local and regional theme parks including Ocean Park, the prospective Disneyland in Shanghai and the Universal Studio in Singapore, members were concerned about the business viability of HKD, and stressed the importance to improve the park's operation and management to withstand the fierce competition.

15. At the Panel meeting on 25 January 2010, HKD advised that it had focused marketing strategies on 24 Mainland cities and would set up the fourth Mainland sales office in Chengdu in March 2010. To capitalize on the latest arrangements under the Mainland and Hong Kong Closer Economic Partnership Arrangement for permanent Shenzhen residents and non-Guangdong residents in Shenzhen to visit Hong Kong, HKD was studying the feasibility of a multiple ticket scheme for visitors from Guangzhou and Shenzhen. To attract local visitors and encourage repeat visitations, HKD would continue to launch a variety of theme-based and innovative events in different seasonal periods. It had also been working with MTR Corporation Limited ("MTRCL"), airlines, hotels, shopping centres and scenic spots such as the Peak and Ngong Ping 360 in organizing joint promotions, while collaborations with other scenic spots were under

discussion.

16. HKD further advised at the Panel meeting on 24 January 2011 that it had expanded the marketing activities from 24 to 28 Mainland cities and it would continue focusing efforts on the top nine markets in Asia and Australia. In order to enhance sales volume, HKD had created evolving product offers to capture different markets and segments, such as maintaining the strategic partnership with local airlines in joint promotions during slow periods and working with various national carriers and budget airlines in key source markets. Panel members considered that HKD should make greater efforts to boost park attendance, explore various marketing strategies and get prepared to compete with the Shanghai Disneyland which was due to be completed by mid-2014. A member also urged the Administration to review and take the lead in the overall planning of tourism infrastructures on the Lantau Island so as to connect the various attractions and enhance the appeal of the Island to tourists.

Park management and financial performance

17. A Member raised a question at the Council meeting on 2 November 2005 concerning whether there was conflict in the Government's roles as the rule-setting authority for the market on the one hand, and as a market participant for being the major shareholder of HKITP on the other. There were also concerns about how the Government directors in the Board of HKITP could monitor the operation of the park effectively, in particular the expenditure on HKD's expansion. Some Members suggested appointing a greater number of independent directors from the business and financial fields as well as the travel trade to the Board to oversee HKITP's operation.

18. At the Panel meeting on 25 January 2010, members welcomed the initiative to enhance the transparency of HKD's financial performance. Some members requested HKD to provide more detailed information in the annual disclosure of its operating and financial results, such as breakdown of operating costs and expenses. They also stressed the importance to put in place a mechanism to ensure that HKD's expenditure would be processed in a transparent manner. Responding to members' concerns raised at the meeting on 25 January 2010 about the financial results in 2008-2009, HKD explained that in-park spending had suffered setbacks due to global economic downturn and the outbreak of swine influenza, whereas the net loss for the year was mainly due to depreciation of assets which would nevertheless continue to generate revenue for the park without affecting cash flow. The park management was confident that the financial performance of HKITP would improve in near future.

19. Members noted at the Panel meeting on 24 January 2011 that although HKD had generated an EBITDA of $221 million in 2009-2010,

HKD still had a net loss of $718 million. The Panel urged HKD to boost park attendance in order to turn the HKD operation into a profit. The Administration advised that HKD would have to press fully ahead with its expansion plan, and continue with its marketing and promotion activities to drive attendance. As HKD was an important brand of Hong Kong, its performance had a direct impact on the image and tourism development of Hong Kong.

20. As for the calculation of base management fee, Panel members considered it difficult to assess the new formula in the absence of information on the financial performance of HKITP in previous years. To safeguard the interests of HKD, it was suggested that the Government should consider calculating the base management fee on the basis of whichever of the old and the new formulae was lower, and a park attendance threshold should be set as a criterion for disbursing the management fee. A Panel member suggested the Government negotiate with WD for pegging the base management fee to a percentage of earnings after interest, tax, depreciation and amortization.

Investment return and economic benefits

21. In a question raised at the Council meeting on 4 June 2008, there was a suggestion that value for money audit on the tourism infrastructure projects, including HKD, should be conducted to assess their performance. Given the unsatisfactory park attendance in the past and the discrepancy in the economic assessment of the expanded HKD project and attendance projections made by WD and the Government, some Members had grave doubts about the viability of HKD, and whether the new agreement would serve the best interests of Hong Kong people. These Members also questioned the reliability of the projection of investment return of HKD as some financial data were not made available by WD.

22. At the Panel meeting on 30 June 2009, a member pointed out that both direct and indirect investment in the project, such as the reclamation works at the initial stage of development and the waiving of claims for dividends from MTRCL in the construction of the Disneyland Resort Line, should be taken into account in calculating the investment return of HKD. There were also concerns about the constraints imposed on the conversion of the $4 billion subordinated shares that represented the land premium for the phase 1 HKD to ordinary shares following the park expansion[9].

9 In 1999, the Government and WD agreed, and FC approved, that the $4 billion subordinated shares would be converted to ordinary shares progressively during the life of the HKD project to the extent that the park's operating performance exceeded the then projected "Base Case". Both sides also agreed that the $4 billion subordinated shares would be converted in a gradual manner, to ensure that the benefits of the ordinary shares held by other investors would not be diluted substantially within a short period of time, and that the conversion would only begin after five years of HKD's operation to allow for fluctuation in business in the early operating years. The permitted conversion ceiling would thereafter rise by 5% per annum cumulatively, thus rendering full conversion of the subordinated shares within 25

Staffing

23. When discussing the creation of job opportunities under the expansion project at the Panel meeting on 4 July 2009, some members stressed that priority should be given to employing local labour force, in particular those Imagineers who had been laid off by WD previously. In addressing members' concern raised at the meeting on 25 January 2010 about staff being laid off and work-related injuries, HKD advised that since the park's opening in 2005, it had not laid off any staff. The number of work injuries decreased from 469 cases in 2008 to 366 cases in 2009. HKD further advised at the meeting on 24 January 2011 that it had since 2007 cooperated with a number of non-government organizations and created an Apprenticeship Programme for persons with disabilities which provided individuals with disabilities nine months of paid job training with transport allowances in tailor-made roles. At present, 20 of them were permanent cast members of HKD.

Corporate social responsibility

24. At the Panel meeting on 24 January 2011, HKD advised that since its opening, it had collaborated with over 600 local charities and non-profit organizations in sponsoring free visits to the park and other activities, benefiting over 1.1 million underprivileged children and families. While commending the work of HKD in this respect, members requested HKD to participate in community service plan and to develop a long-term comprehensive community giving plan to benefit the ones in need, such as underprivileged children and children of ethnic minorities. Members also urged HKD to consider abolishing the daily firework event to protect the environment.

Latest development

25. During the policy briefing on the 2011-2012 Policy Address at the Panel meeting on 14 October 2011, the Administration indicated that HKD was exploring a further expansion within the existing area of the park by adding a new attraction after completing the current expansion plan. Preliminary conceptual planning on the new attraction had already commenced. At the meeting on 17 January 2012, the Administration and HKD will brief the Panel on the operation of HKD in 2010-2011.

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years after park opening possible if the park's business performance could consistently exceed the projections at the time. In order to prevent excessive equity dilution in any one year, an annual cap of 10% on conversion was further agreed.

References

26. A list of the relevant papers with their hyperlinks is in http://www.legco.gov.hk/database/english/data_es/es-hk-disneyland.htm.

Council Business Division 1
Legislative Council Secretariat
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Appendix

Disclosure of information on Hong Kong Disneyland (HKD)'s operating and financial results

The Government and The Walt Disney Company have agreed to publish an annual business review of HKD, starting with the operation year of 2008-2009, that would disclose the following items:

<u>Business indicators (for both the current and the immediately prior financial year, unless otherwise specified)</u>

- Attractions and guest offerings opened/launched in the relevant financial year
- Guest satisfaction for overall theme park and hotel experience
- Total annual park attendance
- Increase/(decrease) in park attendance (indicate as a % change)
- Increase/(decrease) in per capita park guest spending (indicate as a % change)
- Hotel occupancy (indicate as a %)
- Increase/(decrease) in available hotel room nights (indicate as a % change)
- Increase/(decrease) in per hotel room guest spending (indicate as a % change)
- Percentage of visitors by place of origin (Local/China/International)
- Number of full-time and part-time staff employed during the financial year

<u>Aggregate financial indicators (for both the current and the immediately prior financial year) in HK$ millions</u>

- Revenues
- Costs and expenses
- Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA)
- Depreciation and amortisation
- Net finance costs
- Net profit/(loss)
- Non-current assets
- Current assets
- Non-current liabilities
- Current liabilities
- Net Assets/Liabilities
- Cash provided (used) by
    - operating activities
    - investing activities
    - financing activities
- Net increase/(decrease) in cash

In the disclosure in respect of the operation year of 2008-2009, the 2007-2008 figures will also be shown for comparison and reference.

(Source: Extracts from the Administration's supplementary information in LC Paper No. CB(1)2206/08-09(02) for the Panel on Economic Development meeting on 10 July 2009)