2.2: Invest HK$10bn in a 2m sf "Sub-Culture" underground mall in the West Kowloon Cultural District to (1) enhance TST's retail quantum and range of experience as a global shoppers' paradise and (2) generate recurrent income to support the development of arts and culture in Hong Kong

The theme of Hong Kong "bursting at the seams" in the Golden 5 Years cannot be clearer than when one stands in the middle of Tsimshatsui (TST), a global shoppers' paradise with its main streets reportedly grossing more sales than London's Oxford Street/Tottenham Court Road and New York's Fifth Avenue. With no new space in the pipeline, ever-rising rents and ticket prices, packed shops, overflowing pavements and jammed streets will conspire to chase customers away from Hong Kong.

Hong Kong is bursting at the seams with tourists and shoppers

We need to extend our edge as a shopping destination by adding capacity and capabilities to our city's favourite retail district without delay, or else the extra patronage from the opening of the Express Rail Link in 2015 which will put 30m+ population from the affluent Guangdong cities of Guangzhou, Dongguan and Shenzhen within 48 minutes' reach of the TST terminus, together with the "trend" growth of visitor arrivals, will crowd out the joys of shopping and eating in the World City of Hong Kong. We support Dr. Cheung Kwok Pun's concept of subterranean space in our district and propose adding square footage and service offerings in TST with a 2m sf underground mall, provisionally named "Sub-Culture". Sub-Culture's 1m sf first phase should open in 2017, its 0.5m sf second phase in 2019 and its 0.5m sf final phase in 2021.

To preserve and add to Hong Kong's reputation as shoppers' paradise, we must add square footage and service offerings in TST – a 2m sf underground mall, provisionally named "Sub-Culture" can be a highly useful solution

Providing real and powerful support to the development of art and culture enjoyment in Hong Kong, Sub-Culture should produce net profit of some HK$1bn in its first full year of complete operation. This income amounts to 35% of the spending on arts and culture by the Home Affairs Bureau in 2011/12.

Annual net profit from Sub-Culture can add some 35% to spending on arts and culture

A. What are we investing in?

- A 2m sf art-infused and culture-themed mall with 600+ shops and eateries under the West Kowloon Cultural District (WKCD) which we have provisionally named, "Sub-Culture".
- The financial parameters: If considered as a standalone and un-levered (ie all equity financed) project, the HK$10bn investment should produce a Net Present Value (NPV) of HK$11bn and achieve a full payback within eight years of full opening. The latter compares with payback periods of 36+ and 40-50 years for the Hong Kong-Zhuhai-Macau Bridge and Guangzhou-Shenzhen-Hong Kong Express Rail Link, respectively.

Sub-Culture will produce Net Present Value north of HK$11bn and a full payback within eight years of full opening

- In the project's first full-year's operation upon completion of the entire project, a net profit of some HK$1bn should arise, implying a 10% return on total investment of HK$10bn. To better appreciate why the financial attributes of Sub-Culture are so favourable, it is worth remembering that the cost of land normally accounts for 70-80% of the total development cost of a property project in Hong Kong. As the government already owns the land the main investment it needs making is the construction cost of around HK$4,000psf.

An Ungeared Internal Rate of Return of 11% is exceptional in the property world

- The absence of a hefty upfront cost for land has also greatly lessened the sensitivity of its time-adjusted cash value to the rate of discount. Hence, Sub-Culture carries a very high Internal Rate of Return (IRR) of 11%. In other words, the discount rate one has to adopt in order to nullify the project's NPV is 11%. This means that the lower one's cost of fund, the higher will the project's NPV. As comparison, the yield on US 10-year treasuries is around 2% and in our computation, we have adopted the discount rate of 4% as adopted by the government for the Guangzhou-Shenzhen-HK Express Rail Link which will situate next to Sub-Culture.

Art/Culture with Food/Goodies may pair like good food and wine

- The externalities: While there is no "magic formula" that guarantees success of any new undertaking, with 8m sf of space for performance and art appreciation above ground in WKCD, the 2m sf of retail area that lies below it does not appear excessive, especially when Hong Kong can easily absorb the additional capacity with the rising number of customers to our services. Just as Broadway in New York City is supported by shops and restaurants within walking distance, the pairing of the heart/vision/hearing Vs mind with stomach/eye/tactile experience of shopping may yet prove to be as enjoyable as good food and wine.

- Also, it should not take much to realize the possibility that what starts out as a shopping expedition for many in Sub-Culture may lead to a lifetime love affair with the arts when shoppers experiment with attending an exhibition or a performance above ground in WKCD.

A lifetime love affair with the arts may start with a handbag or an iPad

- The ownership structure: While making little or no difference to operations, the financing and ownership of Sub-Culture can be put under the government's Home Affairs Bureau or the West Kowloon Cultural District Authority (WKCDA). Legislation to set aside the funding is needed to be approved by the Legislative Council in either of the cases. There are pros and cons as to the level of private sector participation in the scheme but this decision can be delayed till the project is completed. Given the significant surpluses in our public coffers and the low returns they tend to generate, an investment in Sub-Culture should offer superior risk-adjusted returns.

Government should start the ball rolling immediately…

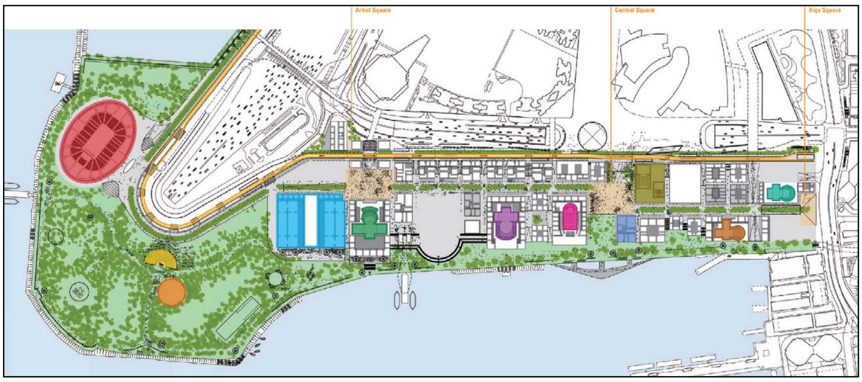
- The operational arrangement: There is no shortage of capable designers, builders and operators of great shopping centres around the world that can bring Sub-Culture to fruition. Through an open and fair process of competition and tenders, the right mix of expertise can be brought together speedily.

B. Why should we invest in Sub-Culture?

We believe there are two major reasons supporting the proposal of investing in Sub-Culture:

1. **Reinforce TST's prominent position as a shoppers' paradise and capitalise on the traffic brought by the HK$62bn Guangzhou-Shenzhen-Hong Kong Express Rail Link which should open in 2015.** (for a more detailed discussion please read on)

2. **Improve the quality and range of services offered by the HK$22bn WKCD by attracting more traffic and providing complementary enjoyment to patrons of art and performances.** Generate recurrent income to support the provision of arts and cultural activities. (for a more detailed discussion please read on)



1. Reinforce TST's prominent position as a shoppers' paradise and capitalise on the traffic brought by the HK$62bn Guangzhou-Shenzhen-Hong Kong Express Rail Link

As we have discussed earlier in section 2, Hong Kong is suffering from acute shortage of retail space, resulting in displacement of traditional retail offerings and soaring rentals which translate to general inflation.

Hong Kong's excellent service quality is highly appealing to tourists, yet the city is heavily constrained in retail space and this is especially true in urban areas. Canton Road, for instance, contributes 10% of Hong Kong total retail sales but only accounts for 2-3% of Hong Kong total shop spaces.

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To safeguard the competitiveness of Hong Kong's flagship shopping district, we need to bulk up the spaces devoted to both tourists and local shopping needs and widen the range of service experience available. In the past few years, many retail offerings that support day-to-day needs of Hong Kong citizens (for instance, traditional restaurants, fast food shops and pharmacies) have been displaced by watch and jewellery and fashion outlets, many of which now dominate Canton Road and half of Queen's Road, Central. According to the Rating and Valuation Department, average high-street retail rentals of Mong Kok, Tsim Sha Tsui and Causeway Bay increased 20-30% in 2010 and 30%+ in 2011.

The lack of new retail space in urban areas has led to surging rentals that have priced out shops that cater for daily living: Rents rose 20-30% in 2010 and 30%+ in 2011

Once the Express Rail Link is completed, an additional 50,000 traffic will arrive per day in the TST area, potentially adding significantly to demand for shopping facilities

Once the Express Rail Link comes into operation in late 2015, 30m+ population of from the affluent Guangdong cities of Guangzhou, Dongguan and Shenzhen will only be a mere 48-minute train ride away from Hong Kong, a shorter travel time than the ferry ride from Hong Kong to Macau. In fact, the MTR Corporation forecasts that by the first full year of operation, in 2016, 99,000 passengers will travel between Hong Kong and mainland (both ways) by the Express Rail every day, i.e. around 50,000 passengers arrive at Hong Kong every day.

By 2016, around 50,000 passengers will arrive at Hong Kong by the Express Rail Link every day; It may take less time to travel to Hong Kong from Guangzhou than the ferry ride from Hong Kong to Macau

With Express Rail Link bringing some 50,000 arrivals every day, this traffic will add a significant burden to the foot traffic passing through the major malls in the TST area today: 150,000 at Harbour City and 100,000 at The Elements. In the next four years and before the Express Rail Link is opened, it is expected that arrivals at TST will grow at a compound rate of 10-15% a year, adding 50-80% to current flows. Let us not forget that the 50,000 Express Rail Link daily arrivals has not included the traffic drawn by WKCD, which could number 11,000 visitors per day according to the economic assessment conducted by the Financial Secretary's Office in 2007. These traffic numbers serve as a high-level indication that an additional mall in the TST area is justified. If nothing is started today, there may be a need to pedestrianise Canton Road within a few years.

In the next four years and before the Express Rail Link is opened, arrivals at TST may add 50-80% to current flows

2. Improve the quality and range of services offered by the HK$22bn WKCD by attracting more traffic and providing complementary enjoyment to patrons of art and performances

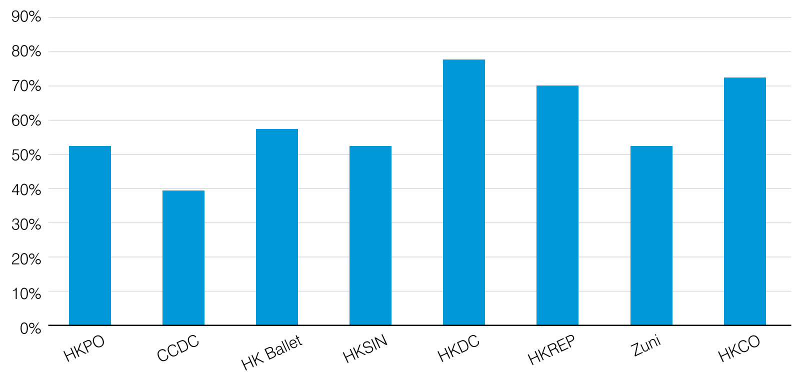
WKCD, at least in its early stages of operation, can rely on other facilities such as retail to help drive traffic

WKCD is the first large-scale art and cultural complex Hong Kong has ever planned and built, a right step for Hong Kong aspiring to be the next World City after London and New York.

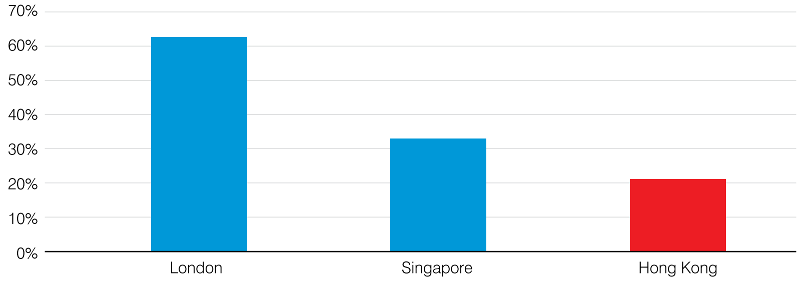
In Hong Kong, arts and cultural facilities unfortunately cannot attract enough patrons to sustain themselves financially and should require other attractions to help drive traffic

An inconvenient truth is that most local arts and culture groups are not financially self-sustainable. Taking the example of the most heavily-subsidised "Big Nine" performing art groups (namely the Hong Kong Chinese Orchestra (HKCO), the Hong Kong Dance Company (HKDC), the Hong Kong Repertory Theatre (HKREP), the Hong Kong Philharmonic Orchestra (HKPO), the Hong Kong Sinfonietta (HKSIN), the Hong Kong Ballet (HK Ballet), City Contemporary Dance Company (CCDC), Chung Ying Theatre Company and Zuni Icosahedron (Zuni)), ticket sales can only generate an average of <40% to cover their operating expenses. One cause for the low profitability is Hong Kong people's lack of demonstrated interest in cultural activities. For instance, while 63% of Londoners and 33% of Singaporeans have seen a performance in the past 12 months, only 21% of Hong Kong citizens have done so. Therefore, other attractions, including retail, are helpful in generating traffic.

Government Grants as Percentage of Total Revenue



Source: Annual reports of HKPO, CCDC, HK Ballet, HKDIN, HKDC, HKREP, Zuni & HKCO



In fact, more and more cultural facilities around the world have started to co-locate with commercial offerings such as retail to drive patronage. A famous example is the Mori Art Museum, a contemporary art museum on the 53rd floor of the 54-level high Mori Tower in the Roppongi Hills area in Tokyo, Japan. The museum, despite having no permanent exhibitions of international acclaim, still attracts 1.5m traffic per year (the 24th most popular art museum in the world according to the Art Newspaper) - mostly leveraging the traffic to the sky-deck observatory and the 0.48m sf shopping mall at the Roppongi Hills.

More and more cultural facilities around the world have started to co-locate with mass offerings such as retail to drive patronage eg. Mori Art Museum in Roppongi Hills, Tokyo

The operational surplus from the extra mall can help finance capital shortage and subsidise more arts and cultural activities

As construction costs have risen 60% since the approval of the HK$21.6bn endowment to WKCDA in 2008, it is widely reported that the authority is in short of cash to finance the construction of all its originally planned arts and cultural facilities. The government should take advantage of the effort in assessing Sub-Culture to bring all costings of WKCD up to date and allow for extra costs in connecting the two facilities. With inflation not expected to abate anytime soon, the biggest disservice to Hong Kong is to procrastinate while costs escalate and art and tourist opportunities evaporate.

The biggest disservice to Hong Kong is to procrastinate while costs escalate and art and tourist opportunities evaporate

From WKCDA's latest Development Plan, it seems that the authority is planning to seek public-private partnership opportunities to help fund the construction and operation of certain facilities such as the Mega Performance Venue, yet whether this arrangement is commercially viable remains uncertain. However, Hong Kong people have already waited for 13 years since these facilities were promised back in 1998 and WKCD remains a barren piece of land. Therefore, we believe a possible way for WKCDA to overcome its financial burden is to obtain extra funding to complete its facilities as soon as possible and the government can rely on future incomes it derives from Sub-Culture to make good possible future shortfalls in WKCDA.

By obtaining extra funding to build Sub-Culture, WKCDA can fund its capital shortage and loss-generating cultural facilities by the HK$1bn annual income from Sub-Culture

Proposal

We propose building a 2m sf 600+-shop underground mall, Sub-Culture, in WKCD to cater for visitors and residents in TST as well as potential traffic brought by the Express Rail Link. The mall is comparable in size and number of shops as Harbour City (2m sf, 700+ shops), compared with the nearby The Elements which houses 220 shops in 1m sf of space. It should be noted that when The Elements opened for business, it added 1m sf or 50%, to the mall supply of Harbour City in a soft market and the subsequent prospering of both has illustrated the significant size of demand for shop space in the district, even before there was suggestion that a HK$62bn Express Link with Guangzhou would land in the middle of this market. Sub-Culture should provide, in addition to range of goods and services offered by shopping centres, spaces for galleries, auction houses and other art and design-related businesses. Unlike the arrival of The Elements, Sub-Culture's first phase of 1m sf in 2017 will only add 33% to the combined spaces of The Elements and Harbour City and in market conditions that will likely exceed the current ebullience as it opens one year after the opening of the Express Link. The addition of the two tranches of 0.5m sf of spaces will open with a two-year gap with the earlier phase, providing the flexibility to put right any problems with footfall and design before more capacity is introduced.

Mode of operation

The government or a public body should start the project and only consider its longer term future after running the completed projects for a few years. The subject property is a shopping centre and this requires top professional advice which does not come likely arise from public consultation.

Estimated construction timeframe

9 years

Estimated investment

HK$10bn

Estimated payback period

8 years (after full opening in 2021)

Net present value

HK$11.1bn

(Timeframe: 30 years, 2012-2041; nominal discount rate: 4%)

Internal rate of return

10.9%

(Timeframe: 30 years, 2012-2041)

Financial model

1. Construction costs

Estimated Sub-Culture Construction Costs

Benchmark Unit Cost (HK$ psf)*	Unit Cost in Our Estimation (HK$ psf)	GFA (m sf)	Total Cost (HK$ bn)
1,625+	4,000	2	10

*Taken from Quarterly Construction Cost Review Third Quarter 2011, Davis Langdon & Seah

2. Operating costs

Benchmark (% of revenue)	Our Estimate (% of revenue)
Langham Place (2011): 21.1	25

3. Revenues

Estimated Sub-Culture Annual Revenues

Benchmark Unit Revenue (HK$psf)	Benchmark Occupancy Rate (%)	Unit Revenue in Our Estimation (HK$psf)	Occupancy Rate in Our Estimation (%)
Habour City (2011): 130	Habour City (2010): 96	50	95

*Taken from Quarterly Construction Cost Review Third Quarter 2011, Davis Langdon & Seah

4. Timeline

2012	First Phase construction	
2013		
2014		
2015		
2016		
2017	Second Phase construction	First Phase opening of 1m sf
2018		
2019	Third Phase construction	Second Phase opening of 0.5m sf
2020		
2021		Third Phase opening of 0.5m sf

5. Assumptions

1. Nominal Discount Rate = 4%

   Benchmarks: 4% (Guangzhou-Shenzhen-HK Express Rail Link)

   5.3% (HK-Zhuhai-Macau Bridge)

   6.1% (WKCD)

2. Inflation = 5% (2012-2014), 3% (2015-2032)

   Benchmarks: (HK Census & Stat. Dept.) 5% (2011)

   3% (2008-2011)

   2% (2004-2011)

3. Escalations of costs: 5%
4. Capital Expenditure Phasing: 2-1-1-1-1-1-1-1-1
5. Financial Model Timeframe: 30 years (2012-2041)
6. Estimated Rent Growth (Yoy)

Estimated Rent Growth

Benchmark Rent Growth (Yoy)	Estimated Rent Growth (Yoy)
6% (Savills Research & Consultancy, 1997-2011) **15% (Savills Research & Consultancy, 2004-2011)**	6% (since opening)

7. Practicality Assumptions: Lettable area = 70%