

## THE HONG KONG HOUSING AUTHORITY

### Memorandum for the Housing Authority and Strategic Planning Committee

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

#### PURPOSE

The purpose of this paper is to seek Members' agreement -

- (a) in principle to divest the Housing Authority's (HA) Retail and Car-parking (RC) facilities;
- (b) to take forward the divestment project according to the broad strategy as described in paragraph 10;
- (c) of \$120 million to meet the initial expenses for appointing advisers and other consultants required for the divestment project; and
- (d) to establish an HA Supervisory Group to monitor and steer the divestment project with terms of reference as set out at [Annex B](#).

#### BACKGROUND

2. The HA currently holds approximately one million square metres of retail facilities and some 100 000 car-parking spaces, amounting to some 11% and 16% of the market respectively.

3. Divestment of the HA's RC facilities was first mooted by a consultant commissioned by the HA in 2000, and was recommended by the Report on the Review of the Institutional Framework for Public Housing published in June 2002. Thereafter, a consultant was appointed to study various options for the divestment and to recommend the way forward. The divestment strategy outlined in paragraph 10 below is based on the findings of this consultancy study. A consultancy summary is at [Annex A](#).

## **REASONS FOR DIVESTMENT**

### **Withdrawal from commercial operation**

4. Divestment of the HA's RC facilities would enable the HA to focus its resources on its core function as a provider of subsidized public housing. Furthermore, the facilities concerned are likely to generate better returns under private sector ownership and operation, which will in turn have a positive impact on the overall economic development of Hong Kong.

### **Tiding over budget deficit**

5. Following the announcement of Government's new housing policy in November 2002, the production and sale of HOS flats have ceased indefinitely and the sale of TPS 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. The HA's cash balance is forecast to decrease from \$22 billion at the beginning of 2003/04<sup>Note 1</sup> to minus \$5.5 billion by the end of 2005/06. 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.

### **Other options considered**

6. There is no viable option other than divestment to relieve the HA of the responsibility for operating the RC facilities on a commercial basis.

7. If the HA does not divest its RC facilities, Government may need to provide substantial funds shortly to the HA to meet its serious cash flow deficit problem. This may not be practicable given that Government similarly has a significant fiscal deficit. Alternatively, the HA may raise debt capital against rental income generated from the RC facilities, with the facilities being pledged as collateral. However, the maximum amount of debt capital that can be raised in this way is likely to be no more than 40% to 50% of the value of the RC facilities, vis-à-vis up to 90% of the value under the divestment strategy proposed in paragraph 10 below.

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*Note 1* Per budget 2003/04. The actual opening cash balance for the year was \$27.5 billion.

## PROPOSED DIVESTMENT STRATEGY

8. A number of divestment options have been considered which include traditional property company IPO and outright sale. These options are considered less desirable than the proposed divestment strategy in paragraph 10 below due to various reasons, including comparatively lower divestment proceeds, possible impact on the local property market, and lack of broad retail participation. Moreover, technical constraints, particularly in relation to the legal title of the RC facilities, also affect the choice of an optimal divestment strategy.

### Technical constraints

9. As the land on which the RC facilities operate are generally vested in the HA by Government, in the first place the HA will need to acquire the relevant land leases for the purpose of the divestment. Since these facilities are generally integral to public housing estates<sup>Note 2</sup>, Government cannot grant leases for the facilities in isolation. As a result, land leases together with the necessary Deeds of Mutual Covenant in respect of some 130 rental estates will have to be procured. The processing of these documents is estimated to take a few years to complete, subject to sufficient resources being made available to relevant Departments<sup>Note 3</sup>.

### Proposed strategy

10. To tackle the above intrinsic constraint, the following broad strategy to take forward the divestment is recommended -

- (a) a new company with characteristics<sup>Note 4</sup> of a 'Real Estate Investment Trust' (REIT) will be established;
- (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. On this basis, the company will make an initial public offering (IPO) on the Stock Exchange of Hong Kong;

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*Note 2* Public housing estates include rental estates, TPS estates, HOS courts, and housing estates covered by the Mortgage Subsidy Scheme or Buy or Rent Option Scheme.

*Note 3* These refer to Lands Department, Buildings Department and Government Property Agency.

*Note 4* 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. Some degree of flexibility would be maintained on whether the new company should be a REIT or one with REIT characteristics as the Securities and Futures Commission is now considering regulations for REITs with a view to allowing such investment vehicles in Hong Kong.

- (c) at a later stage when preparation of relevant leases are completed, the HA will transfer the legal title 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: a majority proportion of the sale amount will be paid immediately after the IPO; the balance will be paid upon transfer of the legal title.

11. The proposed divestment strategy will enable the HA to realize the divestment proceeds within a relatively short time frame. The company's REIT-like characteristics will also attract valuations of the company close to its net asset value. Moreover, the proposed strategy will provide an opportunity for investors' participation in the ownership of the RC facilities through the capital market, and minimize the impact of the divestment on the local property market. The risk of disruption to existing tenants and services will be low, and the HA staff will be provided with an opportunity to seek employment with the company which will have to recruit a good proportion of its key personnel from the HA in order to meet the track record requirements for the purpose of the IPO.

## **RELATED ISSUES**

### *Divestment proceeds*

12. Under the current financial arrangements between Government and the HA, the value of land for the non-domestic portion of public rental housing estates and HOS courts is treated as Government's equity investment in the HA. The return on this investment is reflected in the Government receiving 50% of the net operating surplus generated from the HA's non-domestic operations.

13. Although Government has a financial stake in the HA's RC facilities, it has agreed in principle to allow the HA to retain the full proceeds from divestment to meet its cash flow deficit.

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

14. Although we target at a 100% divestment of the RC facilities, a preliminary appraisal indicates that a small proportion of the RC facilities may be unsuitable for transfer to the new company because of their poor location, small scale, old age or obsolescent condition. Their inclusion will likely lower the

perception of the overall asset quality and affect the valuation of the RC portfolio. Alternative means will have to be devised to deal with these properties on a case-by-case basis, such as outright sale or change to other designated uses.

*Divested RC facilities subject to Buildings Ordinance control*

15. At present, all properties of the HA and Government are exempted from control by the Building Authority. After the divestment, such exemption will no longer apply to the RC facilities. For the purpose of the divestment, we will have to compile plans and records of the RC facilities to facilitate future building control, and identify and arrange for implementation of consequential works, if any, to demonstrate that the standards set down in the Buildings Ordinance and other allied statutory building requirements are met.

**STAFFING ARRANGEMENTS**

16. The divestment proposal would affect about 500 departmental and 200 general grade and contract posts in the Housing Department (HD), ranging from professional to front-line grades/ranks.

17. During the new company's initial phase of operation, a good proportion of the existing RC staff are likely to be required to support the new company, through, possibly, temporary secondment or service contracts. There will be opportunities for HD staff to be recruited by the new company given their operational knowledge and experience, especially to meet the management track record requirements for the purpose of listing.

18. While it is premature to assess the number of staff likely to be recruited by the new company to be established, the divestment may result in some surplus staff as the new company progressively phases in its own staff. We will make full use of the current voluntary retirement scheme and natural wastage to mitigate the potential surplus staff. In addition, we will explore all possible measures to deal with the problem, including redeployment to other duties, non-renewal of contracts, possible secondment to other departments, e.g. the Lands and Buildings Departments, and where necessary, appropriate exit mechanisms.

19. We will communicate with the affected staff and work with them in developing appropriate arrangements for redeployment and other exit possibilities. While keeping options open, we will reassure staff that we will

explore all possible means to facilitate those staff who wish to remain in the service to continue to have a career.

## **COMMUNICATION WITH STAKEHOLDERS**

20. We will arrange extensive briefings for all affected staff /staff unions to explain to them the divestment initiative and listen to their views and concerns. Staff feedback will be encouraged via the HA Intranet and dedicated fax lines. Moreover, senior management and grade management will conduct goodwill visits and focus group discussions with a view to mitigate staffs' possible uncertainties. We will involve staff as early as possible in working out appropriate redeployment arrangements and develop an appropriate exit package, if required, in consultation with Government. To enhance transparency of the consultation process, we shall keep staff involved of views, suggestions and concerns through our in-house e-newsletter "Housing Dimension".

21. For the other stakeholders, including tenants of the RC facilities, representatives from housing concern groups and resident groups, the real estate industry, academics and political parties, we will brief them on the divestment initiative and listen to their views and concerns. A press release will be issued after the divestment proposal is agreed by the HA. Besides, meetings will be arranged with interested parties upon their request. We will duly reflect the stakeholders' views and concerns to the new company for consideration.

## **FINANCIAL IMPLICATIONS**

22. Based on the consultant's preliminary estimate, divestment of the HA's RC facilities will generate net proceeds of over \$20 billion<sup>Note 5</sup>. The actual valuation will be conducted by the global coordinator(s) to be appointed, 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 involved here (such as prevailing market conditions at the time of IPO), there will be flexibility, as it should, in the final valuation. Notwithstanding that, we should endeavour to ensure that the valuation is based on real market situations, and there is no question of launching the IPO below fair

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*Note 5 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, taking into account market, vacancy and other relevant factors, and applying discount rates of between 10% to 14%.*

market price.

23. Subject to Members' agreement of the proposed divestment strategy in paragraph 10 above, we will start the process for appointment of global coordinator(s) and other necessary consultants for the project. The total expenditure to be eventually incurred by the HA on the divestment project over a four-year period (between 2003/04 and 2006/07) is estimated at about \$1 billion. This includes underwriting commission, consultancy fees, IPO-related marketing expenses, and expenses relating to the preparation of land leases and compilation of plans and records for building control purposes, but does not include any expenditure on a possible exit package for staff (see paragraph 24 below). A substantial part of the expenditure will be deducted from the proceeds from the IPO. We estimate that the HA will have to incur an initial expenditure in the sum of about \$120 million in 2003/04 to cover the appointment of certain advisers and consultants. It should however be noted that the proceeds and expenses above are only broad-brush estimates which may need further adjustments in due course.

24. The above estimated expenditure has not taken into account the financial implications of a possible exit package to be offered to civil servants in the HA to cater for the divestment. It is not possible to quantify them at this stage. If such a package is offered, the HA will have to bear the cost of any ex-gratia payment or enhanced monthly pension, whilst Government will bear the normal portion of the commuted and monthly pension.

## **ESTABLISHMENT OF AN HA SUPERVISORY GROUP ON DIVESTMENT**

25. For a project of such a magnitude and importance, close monitor and steer from the HA is necessary. As the divestment project involves cross-cutting issues related to HA's commercial properties, finance and human resource management, it is proposed that a dedicated Supervisory Group on Divestment be set up under the HA to monitor and provide advice and guidance to the Department on the implementation of the project. Proposed terms of reference of the Supervisory Group are at [Annex B](#).

## **RECOMMENDATIONS**

26. It is recommended that Members -
- (a) agree in principle the proposal to divest the HA's RC facilities;
  - (b) agree to the broad divestment strategy proposed in paragraph 10 above and the appointment of global coordinator(s) and other advisers/consultants necessary for its implementation;
  - (c) note the financial implications as referred to in paragraphs 22 to 24 above;
  - (d) agree to the supplementary funds of \$120 M to meet the initial expenses in 2003/04 as referred to in paragraph 23 above; and
  - (e) agree to the establishment of a Housing Authority Supervisory Group on Divestment to monitor and steer the divestment project with terms of reference as set out in [Annex B](#).

## **WAY FORWARD**

27. Subject to Members' agreement of the above recommendations, we will proceed to appoint the global coordinator(s) and other necessary consultants as promptly as possible to assist in implementing the divestment. Our current plan is to set up the new company and to list it on the Hong Kong Stock Exchange, tentatively, in 2004/05. We will arrange intensive briefings for our staff and communicate with our stakeholders on the divestment initiative shortly after Members' agreement of the divestment proposal.

## **ADVICE SOUGHT**

28. Members are invited to agree to the recommendations set out in paragraph 26.

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c.c. Members of the Commercial Properties Committee  
Members of the Finance Committee

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**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 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 have reviewed 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 -

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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.

- (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 will 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 real estate investment trust (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

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<sup>2</sup> REIT legislation is not currently in place. Please refer to Paragraph 21 for more details.

- (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.

## **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.

**Housing Authority Supervisory Group on Divestment**

**Proposed Terms of Reference**

1. In accordance with the broad direction approved by the Housing Authority (HA) in respect of the divestment of its retail and car-parking (RC) facilities, to consider and decide details of implementation, including but not limited to -
  - (a) formulation of the divestment plan; and
  - (b) optimization of the RC portfolio for divestment.
2. To consider and decide the manpower and staff consultation strategies in relation to the divestment project.
3. To consider and decide the public communication strategy in relation to the divestment project.
4. To report to the HA on progress of the divestment project from time to time and, where appropriate, seek its steer.