The Linneman Letter

Volume 20, Issue 1 | Published since 2001 | Spring 2020

The following is an excerpt from the Spring 2020 edition of The Linneman Letter.

What's Happening in Hong Kong?

Formerly a British colony, Hong Kong has long been the shining star of Asia's economy. However, the famous portal between the East and West has come under attack by its own people and, more recently, by the Coronavirus (COVID-19) outbreak. Why did this happen? And what's the current situation?

The protests in Hong Kong began last summer after Hong Kong's unelected Chief Executive Carrie Lam introduced the Fugitive Offenders amendment bill, which citizens feared would subject them to mainland China's jurisdiction and legal system. When Hong Kong was handed over to China in 1997, the "one country, two systems" principle was established. This rule allowed Hong Kong to retain its own economic and administrative system, while being an autonomous Chinese territory. As a Special Administrative Region of China, Hong Kong was to keep its capitalist economy, currency, legal and legislative systems, and freedom until 2047. Despite this, Hong Kong's citizens cannot directly elect their political leader or legislators, putting them in further fear of Beijing's increasingly authoritarian power. The people of Hong Kong do not trust China's government or judicial system and feel that their rights under the agreement are being encroached and that freedom under Xi is "heading the wrong way." Hong Kong has one of the largest wealth gaps in the world and is perhaps the world's most expensive city in which to buy a home. The significant inequality and poor living conditions experienced by much of the population has caused sentiments of anger, adding fuel to the fire. Although the protests began peacefully, clashes between residents and the police quickly escalated into riots and standoffs involving tear gas, rubber bullets, and explosives.

Since the Coronavirus hit, the number of protests has dwindled. However, Hong Kong citizens are still rioting in the form of smaller, more localized strikes. More importantly, the virus has highlighted xenophobic sentiments against mainland Chinese. Many Hong Kong residents grow angrier because they believe the mainland Chinese brought a potentially fatal disease to their territory, sparking bitterness and increasing the acceptability of violent protest tactics. Hong Kong is in a state of virtual lockdown: schools are closed, most people are working from home, and the border with China has effectively been closed.

The double-whammy of the protests and COVID-19 has undoubtedly hurt the Hong Kong economy. Hong Kong slipped into a recession for the first time in a decade, contracting 2.9% year-over-year through the fourth quarter of 2019. Retail sales were down a staggering 21.4% in January 2020 and will be reported down further for February due to the absence of Chinese New Year sales, which will not be immediately available due to the current situation. Tourism, one of Hong Kong's economic pillars, has taken a massive hit. Visitor arrivals fell to fewer than 3,000 in February, a level that is lower than what was seen during the 2002 SARS epidemic. Hong Kong's benchmark stock index, the Hang Seng index, has experienced significant volatility, falling 31% between the January 2018 high and March 2020. In lockstep with the U.S., Hong Kong's

A sample of articles available in the complete version of *The Linneman Letter*. To subscribe to *The Linneman Letter*, contact Doug Linneman at dlinneman@linnemanassociates.com.

Table of Contents **(click titles to jump to the articles)**

monetary authority has also cut interest rates by 50 basis points. The protests and coronavirus are likely to have a heavier impact on smaller, medium-sized companies compared to larger listed corporations, as most listed companies have strong balance sheets. The slump in Hong Kong's pillar industries has resulted in a government budget deficit.

In terms of real estate, Hong Kong has historically had high property valuations, stemming from the combination of low supply and rising demand in the densely populated city. Developable land is scarce, and most of the land that is available to be developed has been set aside by the government for preservation purposes. Furthermore, the government owns around half of Hong Kong's housing market, meaning that only 50% of stock is available for private markets, driving values up significantly and making home ownership very difficult for those who do not qualify for public housing.

With the protests and coronavirus, many retail stores and restaurants have been forced to shut down. As a result, retail landlords are offering rent reductions, an uncharacteristic concession in the ultra competitive Hong Kong real estate market. Sun Hung Kai Properties, the city's largest developer, reduced rents in February by 30-50%. A large part of this is driven by a lack of tourism from both mainland Chinese (driven away during protests) and foreigners for fear for their lives. Property prices have fallen, leading commercial banks to slash mortgaged real estate valuations and push borrowers into negative equity. While the retail and hospitality sectors have taken the greatest hits, Hong Kong's usually resilient residential sector has seen property prices fall by 6.1% from the June 2019 record high. This "relatively mild" drop has been caused by controlled and consolidated supply, low interest rates, and relatively low loan-to-value ratios for homeowners. Similarly, most of Hong Kong's listed real estate corporations have low leverage due to the risk of floating rates, a factor that will be crucial as the situation plays out.

As Warren Buffett once said, "be fearful when others are greedy and be greedy when others are fearful." Looking at the sentiment in Hong Kong, the current situation is clearly reflective of the latter part of Mr. Buffet's advice. The rate cuts and desperation for economic stimulus present an opportunity to lock in debt at a lower cost. Entering the Hong Kong real estate market now would present significant risk, as the situation is still in early innings and remains extremely volatile. However, investors should gear up and build their war chests in anticipation of buying opportunities once markets stabilize. Investors should be cautious, however, because Hong Kong's long-term future remains uncertain. Its importance as a key financial hub between the East and West is threatened not only by the protests and coronavirus, but also by other cities such as Singapore and Shenzhen, which challenge Hong Kong's economic status.

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For nearly four decades, he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fifth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

Follow us on Twitter:

@P_Linneman

For more information about a subscription to *The Linneman Letter*, contact Doug Linneman at dlinneman@linnemanassociates.com.