

2 Financial Performance

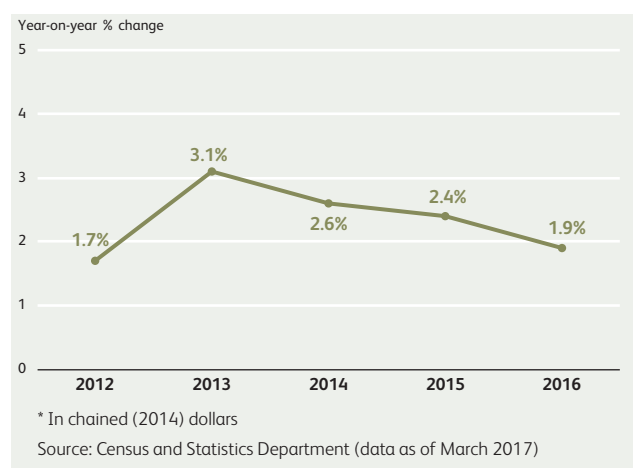
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The Marketplace

Hong Kong economy

The Hong Kong economy picked up slightly with a 1.9 % growth for the full year. Private domestic expenditure increased 1.6 % supported by favourable employment and earnings. Investment expenditure declined by 0.5 % , dragged by the dampened sentiment during the first half of the year. Exports of goods rebounded by 1.7 % upon the stabilisation of Asia markets while exports of services declined at 3.0 % mainly due to the decelerating trend in visitor arrivals.

Real Gross Domestic Product*



Retail

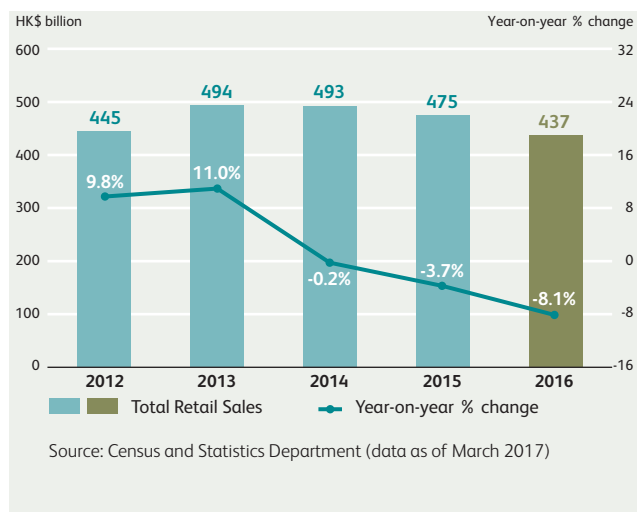
Retail sales recorded an annual decline of 8.1 % as compared to the previous year. During the year, decelerating sales of luxury products and electronic goods were the key reasons for the overall decrease. Some categories, including supermarket and food-related items, remained in positive territory.

A 6.7 % drop in Mainland Chinese visitors during the year was one of the core factors in the overall retail decline, although the rate of decline started to narrow in the second half of the year.

	Categories	2016 growth rate
Key dropping categories	Other consumer durable goods (including electronic goods and computers)	-26.6 %
	Jewellery, watches and clocks, valuable gifts	-17.2 %
Growing categories	Food and alcoholic drinks	+1.7 %
	Supermarket	+0.8 %

Source: Census and Statistics Department (data as of March 2017)

Hong Kong Total Retail Sales

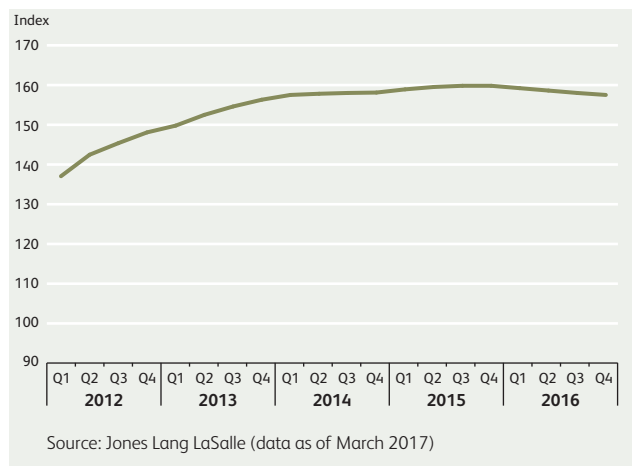


Total Number of Visitors



According to Jones Lang LaSalle, rents for retail premises in prime shopping centres dropped mildly by 1% due to the downturn of the luxury sector.

Premium Prime Shopping Centre Rental Index (2009 Q4=100)



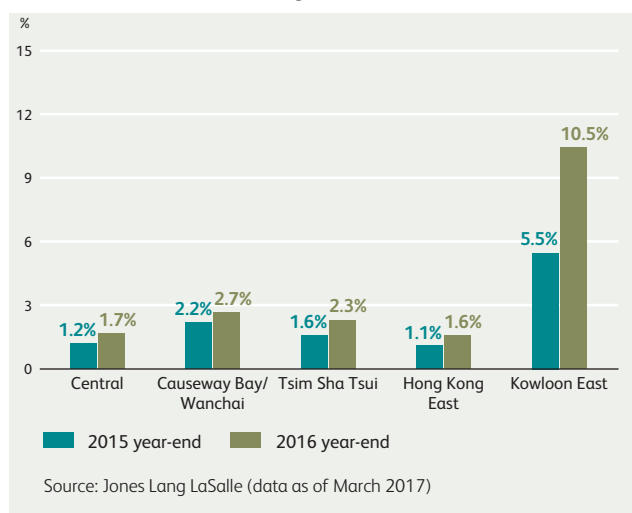
Office

Rents in the Grade “A” office market recorded good growth in general. The primary growth driver was the demand from Mainland Chinese firms, which offset the downsizing and relocation of MNC firms. Mainland Chinese companies took up about 40% of new lettings in Central during the year. However, some sub-markets e.g. Kowloon East, experienced a decline due to mounting supply pressure.

According to Jones Lang LaSalle, new Grade “A” office supply totaled 1.7 million square feet in 2016, which was a similar level to the average of the last 10 years (1.9 million square feet). However, the average net take-up experienced a negative figure of 0.1 million square feet, which was significantly lower than the average of the last 10 years (1.9 million square feet).

As at the end of December 2016, Kowloon East witnessed a substantial increase in vacancy while other sub-markets were generally on par.

Grade “A” Office Vacancy Rate in 2015 and 2016



Grade “A” Office Rental Value

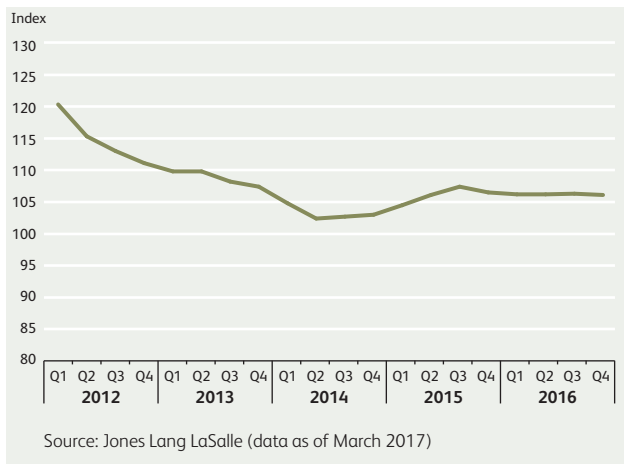


Luxury Residential

Luxury rents were broadly stable despite a lack of traditional demand from MNCs and banks. There was a shift in tenant profiles as demand from Mainland Chinese who have recently relocated to Hong Kong increased.

According to Jones Lang LaSalle, the overall change in luxury residential rents stayed flat at 0.2% in 2016 as compared to the previous year.

Luxury Residential Rental Index (2009 Q4=100)



Management's Discussion and Analysis

Hysan's portfolio of retail, office and residential investment properties has a combined gross floor area of approximately 4.1 million square feet, excluding the site of the forthcoming Lee Garden Three.

Strategy

The Group maintains our commitment to pursue a steady growth of return for our shareholders. The Group's core focus remains in Causeway Bay, our home base for a number of decades, and where the vast majority of our portfolio is situated. In the meantime, the Group actively seeks other investment opportunities beyond our core, as demonstrated by our recent success in a joint-venture bid for two residential sites in Hong Kong's Tai Po.

For our existing properties, we strive to enhance their value through refurbishing, repositioning, redevelopment, and other means of portfolio management. We continue to build a thriving community for our retail and office tenants, underpinned by sound financial management and a dedicated team of employees with invaluable expertise across a broad range of real estate disciplines.

Review of Results

The Group's turnover in 2016 was HK\$3,535 million, an increase of 3.1 % from HK\$3,430 million in 2015. The increase principally reflected overall positive rental reversion within the portfolio. Both the retail and office sectors saw rises, while the residential sector experienced a decline.

The turnover of each sector is shown as below:

	2016 HK\$ million	2015 HK\$ million	Change %
Retail sector	1,969	1,902	+3.5
Office sector	1,292	1,243	+3.9
Residential sector	274	285	-3.9
	3,535	3,430	+3.1

The Group's Recurring Underlying Profit and its Underlying Profit were both HK\$2,369 million, up 3.8 % from HK\$2,283 million in 2015. These indicators primarily reflected the continued improvement in gross profit generated from our retail and office leasing activities. Basic earnings per share based on Recurring Underlying Profit were HK226.29 cents (2015: HK214.83 cents), up 5.3 %.

Our Reported Profit for 2016 was HK\$1,218 million (2015: HK\$2,903 million), a 58.0 % decrease from the year before, principally reflecting the fair value loss (2015: fair value gain) on the Group investment properties valuation recorded this year. This also highlighted the net effect of several factors in play: a worsening retail rental outlook; a persistently positive office rental outlook; a number of enhancement works made, as well as the construction costs incurred for the Lee Garden Three project during the year. The capitalisation rates of each portfolio remained unchanged from those used as at 31 December 2015.

	2016 HK\$ million	2015 HK\$ million	Change %
Recurring Underlying Profit and Underlying Profit	2,369	2,283	+3.8
Fair value (loss) or gain on investment properties located in			
– Hong Kong (net of effect of non-controlling interests' shares)	(1,157)	616	n/m
– Shanghai*	6	4	+50.0
Reported Profit	1,218	2,903	-58.0

* The investment properties are held by an associate of the Group.

n/m: not meaningful

Review of Operations

As at 31 December 2016, about 83 % of the Group's investment properties by gross floor area were retail and office properties in Causeway Bay, and the remaining 17 % was represented by residential properties in the Mid-Levels.

In terms of turnover contributions by the different business portfolios, about 56 % was attributable to retail, 36 % to office, and 8 % to residential properties.

KEY PERFORMANCE INDICATORS

The Group's turnover growth and occupancy rate are the key measurements used for assessment of our core leasing business' performance. The Group's management also uses the property expenses ratio (as a percentage of turnover) to assess cost effectiveness.

Key Performance Indicators	Definition	Business Performance
Turnover Growth	Rental revenue in 2016 vs that in 2015	Retail: +3.5 % (2015 vs 2014: +5.6 %) Office: +3.9 % (2015 vs 2014: +9.4 %) Residential: -3.9 % (2015 vs 2014: -0.7 %)
Occupancy Rate	Percentage of total area leased*/ total lettable area* of each portfolio at year end	Retail: 99 % (2015: fully-let) Office: 96 % (2015: 99 %) Residential: 82 % (2015: 89 %)
Property Expenses Ratio	Property expenses divided by turnover	Remained at 12.1 % in both years of 2016 and 2015

* Source of underlying data: Internal company data

Note: No changes have been made to the source of data or calculation methods used compared to 2015.



RETAIL PORTFOLIO

Turnover ↑ 3.5%	Rental reversion ↑ around 5%	Occupancy 99%	Traffic ↑ around 5%	Overall estimated tenant sales ↓ around 30%
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Hysan's retail portfolio turnover grew 3.5 % to HK\$1,969 million (2015: HK\$1,902 million), including turnover rent of HK\$46 million (2015: HK\$71 million).

The portfolio saw positive rental reversion in rental renewals, reviews and new lettings, with an average increase of around 5 %. The portfolio occupancy was 99 % as at 31 December 2016 (31 December 2015: fully-let).

Our creative retail experiences, including but not limited to new food and beverage outlets, as well as innovative in-mall marketing activities, enable the portfolio to maintain an iconic image as a premier shopping destination with hubs of different price points.

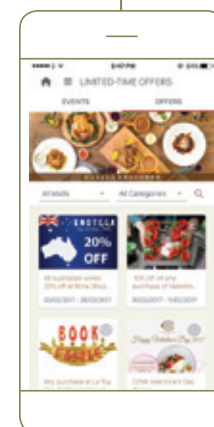
This variety helped our total foot traffic to maintain its growth, and it saw an increase of around 5 %, as compared to the year before. This robust performance was achieved during a period of decline in the number of overseas visitors to Hong Kong.

The estimated overall tenant sales within the retail portfolio, however, experienced a double-digit percentage decline. The estimated sales decrease of certain electronic goods within the portfolio was a main contributor to this relative weakness. Otherwise, the decline was much milder, and was in fact less severe than the decrease experienced by Hong Kong's overall retail sales during the year.

Our trend-setting hub, Hysan Place, saw a footfall growth of around 5 %, as compared to 2015. During the year, we added a number of hip and trendy fashion stores, as well as wellness and sports shops to the tenant mix. These themes also appeared as popular in-mall events, with "Greatest of All Time" iconic sport stars statues and three-pointer shooting games attracting basketball fans from all over the city, while "VR 360 Tennis in the Air" strongly appealed to the racquet and tech-loving crowd. A number of new food and beverage outlets joined the mall in 2016, including the popular Kikusan, Pizza Maru, Green Waffle Diner and Pressed Juices.

The premium Lee Gardens hub continued to register foot traffic growth, against a backdrop of overall decline of visitors in Hong Kong. The footfall increased by more than around 5 % in Lee Garden Two, as compared to the 2015 figure. A number of fashion brands opened at Lee Gardens hub, including Loro Piana, Theory, Pinko and Marina Rinaldi, while the hub's food and beverage offerings remained popular. Two new outlets of affordable international fare, Passion by Gerard Dubois and Panino Giusto were added to the line-up during the year.

Lee Theatre hub also experienced an increase of around 5 % in foot traffic, as compared to 2015. The lower floor flagship stores in Lee Theatre Plaza continued to attract shoppers throughout the year. The Korean brand Dodam Chicken also helped strengthen the dining experience for a younger crowd.

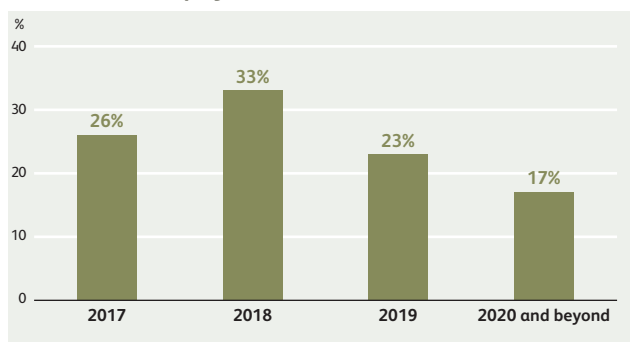


While these three hubs do have their special characteristics, we believe our retail portfolio should be considered in a more holistic manner. We are working to improve the connections among the different hubs, both in terms of physical linkage and the content provided by the tenants, and aim to encourage consumers to shop and dine throughout the portfolio.

In recent years we have run a successful Lee Gardens Office Plus tenant membership programme. In 2016, we upgraded the programme to create a new Lee Gardens Plus and expanded the membership to include staff of retail tenants, as well as residents of Bamboo Grove and Lee Gardens Apartments. We launched this offer-and-reward programme into an application-based one to match the needs of today's tech-savvy users. Offers are now redeemed via the mobile app's QR codes. This initiative is part of our drive to combine online and offline activities.

We also improved our loyalty programme, Club Avenue. An extra tier was added to the structure so that we could cater to more regular moderate spenders. We have also enhanced the Club's facilities and the training of our staff with an aim to provide service that exceeds customer expectations.

Retail Lease Expiry Profile (As at 31 December 2016)



Management's Discussion and Analysis

OFFICE PORTFOLIO

Turnover	Rental reversion	Occupancy
↑ 3.9%	↑ around 25%	96%



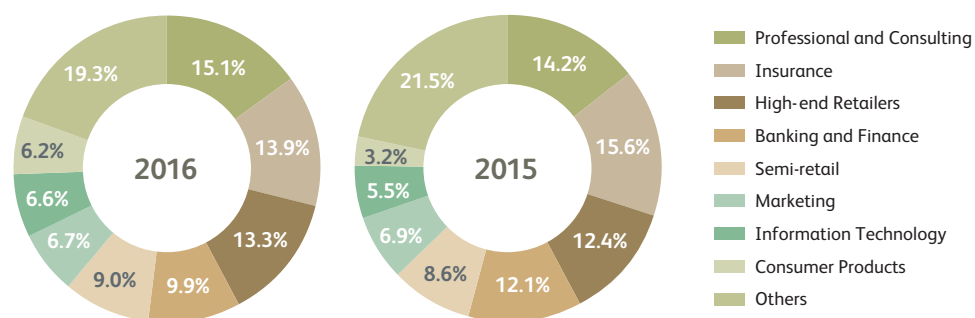
The Group's office portfolio turnover grew by 3.9% to HK\$1,292 million (2015: HK\$1,243 million). This reflected positive rental reversion on renewals, reviews and new lettings, with an average rental increase of around 25%.

The office portfolio occupancy was 96% as at 31 December 2016 (31 December 2015: 99%). Among the available spaces were a number of small units in non-Grade A buildings.

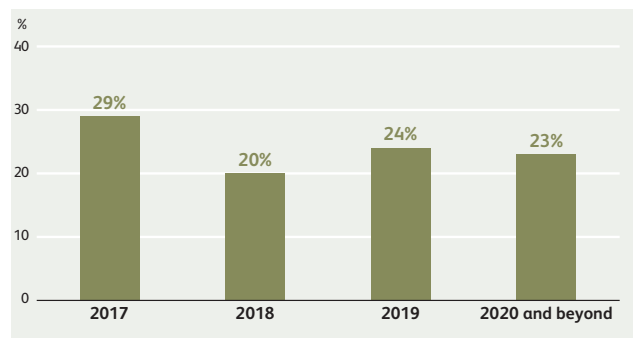
Mainland Chinese banking and financial entities continued to form the backbone of office space demand in Central and Admiralty. The launch of the Shenzhen-Hong Kong stock connect scheme in late 2016 complemented the existing Shanghai link, and is likely to help maintain these entities' presence and expansion in the market. Companies in other industries, looking for quality space with up-to-date facilities, good transport links and cost effectiveness, are placing Causeway Bay and Lee Gardens high on their list of preferences. In 2016, Uber and AXA were examples of renowned international companies joining the portfolio. Southwest Securities, an established investment and securities company in the Greater China region also took up office space, while Prudential Hong Kong expanded its presence in Lee Gardens.

Our tenant mix saw some minor changes in 2016, with professional and consulting services now being the sector occupying the most area, followed by insurance, high-end retailers and banking and finance. These sectors took up 52.2% of our lettable floor area. The well balanced mix saw no category taking up more than 20% of the total lettable area.

Office Tenant Profile by Area Occupied as at Year-end



Office Lease Expiry Profile (As at 31 December 2016)



RESIDENTIAL PORTFOLIO

Turnover
↓ **3.9%**

Rental reversion
↑ **around 5%**

Occupancy
82%



Hysan's residential portfolio (mainly the units in Bamboo Grove on Kennedy Road), recorded a 3.9% turnover decline to HK\$274 million (2015: HK\$285 million). This was largely due to large scale upgrade and renovations. The portfolio's occupancy was 82% as at 31 December 2016 (31 December 2015: 89%).

The rental reversion was positive on renewals, review and new lettings, with an average rental increase of around 5%.

LEE GARDEN THREE PROJECT

The above-ground construction was up to 22/F as of mid-February 2017 and was making good progress towards its expected completion date in the fourth quarter of 2017.

LEE GARDEN ONE ENHANCEMENT PROJECT

The final phase of the ground floor lobby and higher floors' retail space enhancement project was completed in the middle of 2016 as scheduled. Two new food and beverage outlets were added to enhance our restaurant offerings in the building, while Valentino opened its new expanded store in January 2017.



Financial Review

A review of the Group's results and operations is featured in the preceding sections. This section deals with other significant financial matters.

OPERATING COSTS

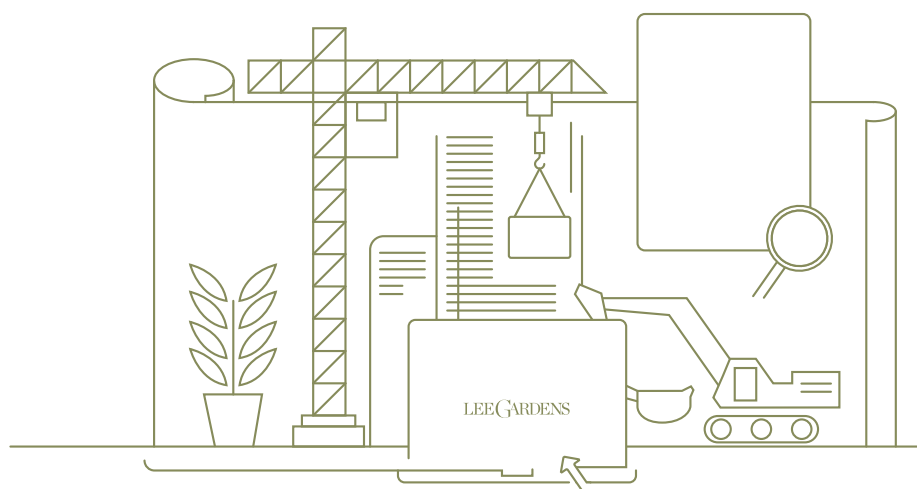
The Group's operating costs are generally classified as property expenses (direct costs and front-line staff wages and benefits) and administrative expenses (indirect costs largely representing payroll related costs of management and head office staff).

Property expenses increased by 3.4 % to HK\$428 million (2015: HK\$414 million), mainly due to higher fees to external leasing agents. The property expenses to turnover ratio remained the same at 12.1 % for both years of 2016 and that of 2015.

Administrative expenses dropped by 6.4 % to HK\$219 million (2015: HK\$234 million). This mainly reflected the reduced payroll related costs due to the resignation of Executive Directors in both years.

FINANCE COSTS

Finance costs, after capitalisation of HK\$14 million (2015: nil) interest expenses and related borrowing costs which were a part of the construction costs of Lee Garden Three, recorded a decrease of 12.7 % to HK\$178 million (2015: HK\$204 million). If the capitalised interest expenses and related borrowing costs were included, the Group's finance costs in 2016 would have been HK\$192 million, a decrease of 5.9 % from HK\$204 million in 2015. The decrease was attributable to the lower average debt level in 2016 as compared to 2015 after debt repayments in both years. A HK\$500 million bank loan was drawn down in the first half of 2016 but the related finance costs were capitalised as part of the construction costs of Lee Garden Three.



The debt repaid in both years were mainly structured on a floating rate basis, which generally carried lower finance costs as compared with fixed rate debts. As a result, the Group's average cost of finance in 2016 was 3.8%, slightly higher than 3.5% reported for 2015.

Further discussion of the Group's treasury policy, including debt and interest rate management, is set out in the "Treasury Policy" section.

REVALUATION OF INVESTMENT PROPERTIES

Fair value loss on investment properties (excluding capital expenditure spent on the Group's investment properties) of HK\$1,187 million (2015: fair value gain of HK\$695 million) was recognised in the Group's consolidated income statement for the year. This principally reflected the net effect of several factors: a worsening retail rental outlook; a sustained positive office rental outlook; a number of asset enhancement works completed, as well as the construction costs incurred for the Lee Garden Three project.

As at 31 December 2016, the Group's investment property portfolio (including property under redevelopment) was HK\$69,633 million, a slight decrease of 0.3% from HK\$69,810 million at 31 December 2015. This valuation was carried out by Knight Frank Petty Limited, an independent professional valuer, on the basis of open market value. The capitalisation rates of each portfolio remained unchanged from those used as at 31 December 2015.

The following shows the property valuation of each portfolio at year-end.

	2016 HK\$ million	2015 HK\$ million	Change %
Retail	33,082	34,230	-3.4
Office	23,832	23,110	+3.1
Residential	7,859	7,833	+0.3
	64,773	65,173	-0.6
Property under redevelopment (Lee Garden Three)	4,860	4,637	+4.8
	69,633	69,810	-0.3

INVESTMENT IN AN ASSOCIATE

The Group's share of results of an associate decreased by 3.7% to HK\$237 million (2015: HK\$246 million). This decline was mainly due to the Renminbi devaluation during the year, which impacts on the value of the Group's share (24.7%) in the Shanghai Grand Gateway project. As at 31 December 2016, properties at Shanghai Grand Gateway had been revalued at fair value by an independent professional valuer. The Group's share of the revaluation gain, net of the corresponding deferred tax thereon, of the associate amounted to HK\$6 million (2015: HK\$4 million).

OTHER INVESTMENTS

In addition to placing surplus funds as time deposits in banks with strong credit ratings, the Group also invested in investment grade debt securities. This helped to preserve the Group's liquidity and to enhance interest yields.

Investment income, comprising mainly interest income, amounted to HK\$50 million (2015: HK\$54 million). This principally reflected a lower average investment amount after repayment of matured debts and the use of cash for share repurchases.

Management's Discussion and Analysis

Cash Flow

Cash flow of the Group during the year is summarised below.

	2016 HK\$ million	2015 HK\$ million	Change %
Operating cash inflow	3,326	2,908	+14.4
Investments	1,331	1,250	+6.5
Financing	1,427	(1,587)	n/m
Advance to a joint venture company	(2,036)	–	n/m
Interest and taxation	(523)	(480)	+9.0
Dividends paid and proceeds on exercise of options	(1,500)	(1,454)	+3.2
Capital expenditure	(847)	(414)	n/m
Consideration for shares repurchased	(395)	(215)	+83.7
Net cash inflow	783	8	n/m

n/m: not meaningful

The Group's net operating cash inflow was HK\$3,326 million (2015: HK\$2,908 million), HK\$418 million higher than in 2015, reflecting the growth in our core leasing business. Net cash from investments was HK\$1,331 million (2015: HK\$1,250 million), mainly attributable to reduction in investments in time deposits and term notes with longer tenors, as compared to 2015. Net cash from financing was HK\$1,427 million (2015: net cash used in financing: HK\$1,587 million), reflecting new bank loans of HK\$1,680 million and repayment of a HK\$250 million bank loan during the year. In 2015, net cash used in financing was HK\$1,587 million, principally due to the repayment of HK\$850 million bank loans and HK\$732 million medium term notes.

Cash in advance to a joint venture company was for residential sites' development in Tai Po. The Group paid dividends of HK\$1,394 million (2015: HK\$1,330 million), being the 2015 second interim dividend of HK107 cents per share and the 2016 first interim dividend of HK26 cents per share.

CAPITAL EXPENDITURE AND MANAGEMENT

The Group is committed to enhancing the asset value of its investment property portfolio through selective asset enhancement and redevelopment. The Group has also in place a portfolio-wide whole-life cycle maintenance programme as part of its ongoing strategy to pro-actively implement preventive maintenance activities. Total cash outlay of capital expenditure during the year was HK\$847 million (2015: HK\$414 million), including the payment of the construction costs of Lee Garden Three.

SHARE REPURCHASE

As part of Hysan's capital management strategy, the Group repurchased 12.59 million (2015: 6.75 million) of its own shares during 2016, which should further enhance shareholders' value, at an aggregate consideration of HK\$395 million (2015: HK\$215 million). The average purchase price per share was HK\$31.24 (2015: HK\$31.78).

Treasury Policy

MARKET HIGHLIGHTS

2016 was filled with uncertainties and unexpected outcomes that will have a significant impact on the years to come. The slowdown of China's economic growth was a major concern in 2016 and the spillover effect had global repercussions especially in the first half of the year. Although China met its target growth rate for 2016, uncertainty remains in 2017 as growth deceleration continues and the debt problem persists. Adding to these concerns are the U.K.'s direction of travel following the referendum vote for "Brexit", the upcoming elections in several European Union countries, and the expected shifts in U.S. economic and trade policy following the election of President Trump.

Although global economic growth continued to be weak in 2016, the U.S. economy showed signs of improvement. The Federal Reserve raised the federal funds rate in December 2016 and signalled further interest rate hikes to come during 2017. Despite changes in U.S. monetary policy, the central banks of the Eurozone and Japan have maintained ultra-low interest rates. Nevertheless, the Hong Kong interest rate outlook will be affected largely by that of the U.S.

CAPITAL STRUCTURE MANAGEMENT

The 3-month HKD Hibor increased from around 0.4% in 2015 to around 1.0% at the end of 2016. Despite the increase in Hibor, the Hong Kong bank loans market continued to have ample liquidity as the credit margin of bank loans for companies with investment grade credit ratings declined moderately in 2016 as compared with 2015.

The outstanding gross debt¹ of the Group increased to HK\$6,305 million (2015: HK\$4,875 million) at year-end 2016, after debt repayment of HK\$250 million and new drawdown of HK\$1,680 million for general funding purposes during the year. All the outstanding borrowings are on an unsecured basis. The Group also arranged a new HK\$500 million committed facility in 2016, which remained undrawn as at year-end 2016.

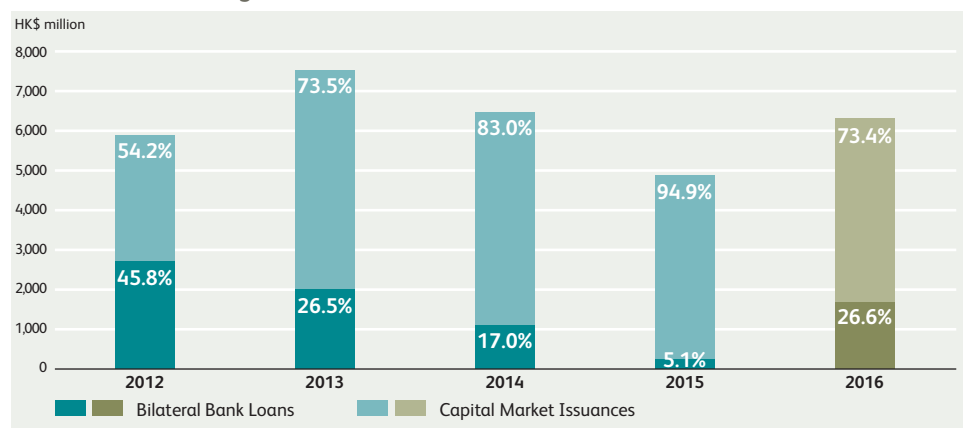
The Group always strives to lower the borrowing margin, to diversify the funding sources and to maintain a suitable maturity profile relative to the overall use of funds. Because of the new bank loans in 2016, debts sourced from the capital market decreased to 73.4% (2015: 94.9%) at year-end of 2016. The Group continued to maintain long-term relationships with a number of local and overseas banks in order to diversify the funding sources. At year-end 2016, seven local and overseas banks provided bilateral banking facilities to the Group as funding alternatives.

¹ The gross debt represents the contractual principal payment obligations at 31 December 2016. However, in accordance with the Group's accounting policies, the debt is measured at amortised costs, using the effective interest method. As disclosed in the consolidated statement of financial position as at 31 December 2016, the book value of the outstanding debt of the Group was HK\$6,293 million (31 December 2015: HK\$4,859 million).

Management's Discussion and Analysis

The following graph shows the percentages of total outstanding gross debts sourced from banks and the debt capital markets in the past five years.

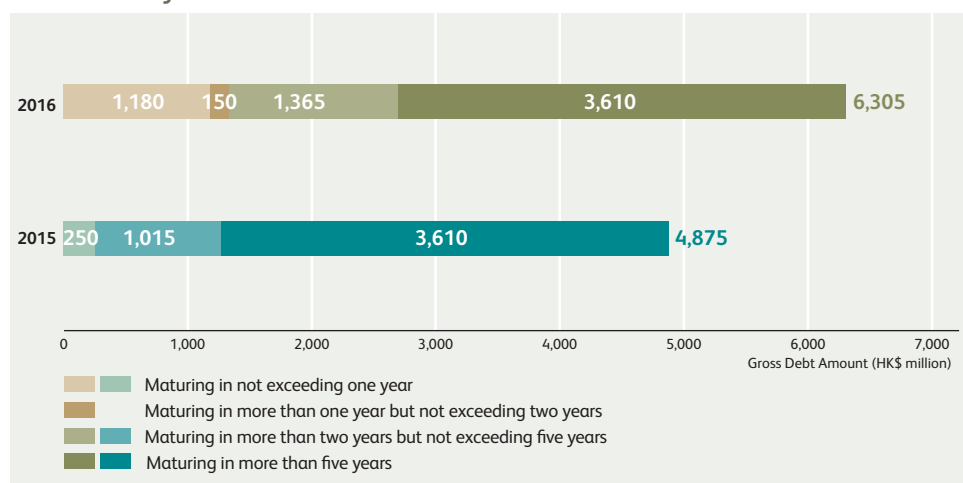
Sources of Financing at Year-end



The Group also strives to maintain an appropriate debt maturity profile. As at 31 December 2016, the average maturity of the debt portfolio was about 4.3 years (2015: 6.3 years), of which about HK\$1,180 million or 18.7% of the outstanding gross debt will be due in less than one year. With ample liquidity in the bank loans market, established relationship with various banks and the investment-grade credit rating, the Group expects to refinance the maturing loans in 2017 without significant refinancing pressure.

The graph below shows the debt maturity profile of the Group at year-end 2016 and 2015.

Debt Maturity Profile at 2016 and 2015 Year-end

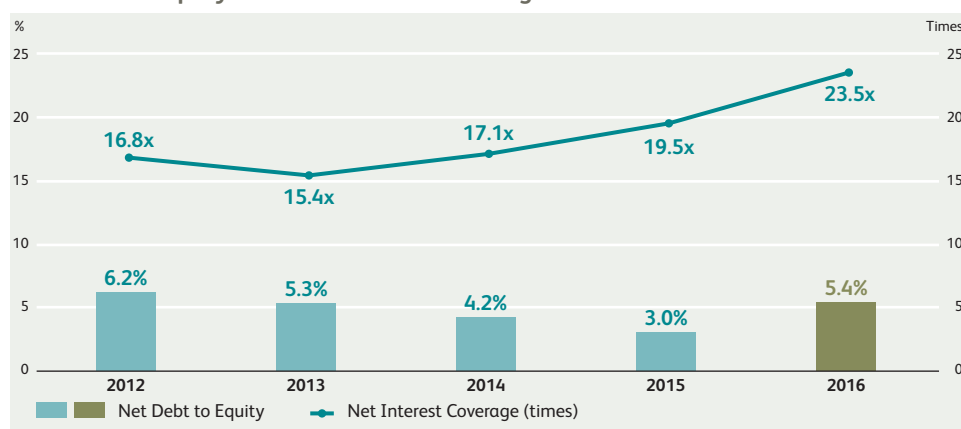


As part of Hysan's capital management strategy, the Group completed repurchases of 12.59 million (2015: 6.75 million) shares through the Hong Kong Stock Exchange in 2016, which would further enhance shareholders' value. Reflecting the stable recurring cash flows from our business, the Group maintained investment-grade credit ratings of A3 as rated by Moody's and BBB+ as rated by Standard and Poor's.

The Group's gearing ratio, as measured by Net Debt to Equity ratio¹, increased to 5.4% at year-end of 2016 (2015: 3.0%), mainly due to a new drawdown in 2016. The Group's Net Interest Coverage² further improved to 23.5 times for 2016 (2015: 19.5 times) as cash inflow from the business remained strong. The low gearing and strong ability to meet interest payments reflected the Group's resilience and capability to raise further debt if there is any need.

The graph below shows the level of leverage and our ability to meet interest payment obligations in the past five years.

Net Debt to Equity and Net Interest Coverage at Year-end



LIQUIDITY MANAGEMENT

As at 31 December 2016, the Group had cash and bank deposits totalling about HK\$2,630 million (2015: HK\$2,804 million). All the deposits are placed with banks with strong credit ratings and the counterparty risk is monitored on a regular basis. In order to preserve liquidity and enhance interest yields, the Group invested HK\$1,155 million (2015: HK\$1,350 million) in debt securities.

Further liquidity, if needed, is available from the undrawn committed facilities offered by the Group's relationship banks. These facilities, amounted to HK\$500 million at year-end 2016 (2015: HK\$750 million), essentially allowing the Group to obtain additional liquidity as the need arises.

¹ Net Debt to Equity is defined as borrowings less time deposits, cash and bank balances divided by shareholders' funds

² Net Interest Coverage is defined as gross profit less administrative expense before depreciation divided by net interest expenses

Management's Discussion and Analysis

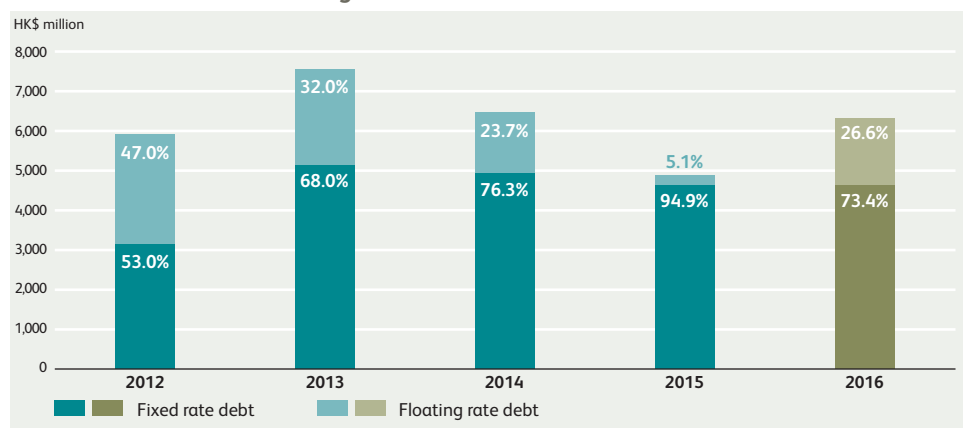
INTEREST RATE MANAGEMENT

Appropriate hedging strategies, if necessary, are adopted to manage exposure to projected movements in the interest rate. Bank loans generally carry lower interest rate as compared with medium term notes. As a result of less bank loans during 2016, the average cost of finance increased slightly to 3.8% in 2016 as compared with 3.5% in 2015.

The fixed debt ratio decreased to 73.4% at year-end 2016 from 94.9% at year-end 2015 following new borrowing of HK\$1,680 million bank loans during 2016. As the U.S. has entered the interest rate normalisation cycle, the Group believes that interest rates will rise in coming few years. We expect the current fixed debt ratio allows the Group to weather the risk of an interest rate hike cycle.

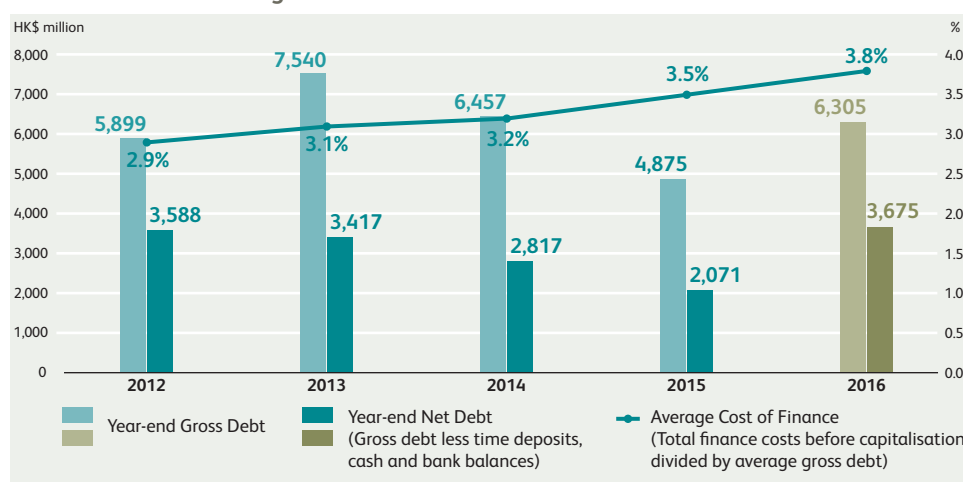
The diagram below shows the fixed rate debt and floating rate debt portions in the past five years.

Fixed Rate Debt and Floating Rate Debt Portions



The diagram below shows the Group's debt levels and average cost of finance in the past five years.

Debt Levels and Average Costs of Finance



FOREIGN EXCHANGE MANAGEMENT

The Group aims to have minimal mismatches in currency and does not speculate in currency movements for debt management. With the exception US\$300 million fixed rate notes, which have been hedged by an appropriate hedging instrument, all of the Group's borrowings were denominated in Hong Kong dollars. For the US\$300 million fixed rate notes issued in January 2013, a hedge was entered to effectively convert the borrowing into Hong Kong dollars.

On the investment side, the Group's outstanding foreign currency balances in cash, time deposits, and debt securities amounted to US\$180 million (2015: US\$160 million) and RMB55 million (2015: RMB135 million), of which US\$98 million (2015: US\$93 million) and RMB55 million (2015: RMB135 million) were hedged by foreign exchange forward contracts.

Other foreign exchange exposure mainly relates to investments in the Shanghai project. These unhedged foreign exchange exposures amounted to the equivalent of HK\$3,497 million (2015: HK\$3,683 million) or 4.4% (2015: 4.7%) of total assets.

USE OF DERIVATIVES

As at 31 December 2016, outstanding derivatives were mainly related to the hedging of foreign exchange exposures. Strict internal guidelines have been established to ensure derivatives are used to manage volatilities or adjust the appropriate risk profile of the Group's treasury assets and liabilities.

Before entering into any hedging transaction, the Group will ensure that its counterparty possesses strong investment-grade ratings to control credit risk. As part of our risk management, a limit on maximum risk-adjusted credit exposure is assigned to each counterparty, which basically reflects the credit quality of the counterparty.

Risk Management and Internal Control Report

Responsibility

Our Board of Directors has the overall responsibility to ensure that sound and effective risk management and internal control systems are maintained, while management is responsible for designing and implementing risk management and internal control systems to manage risks. Sound and effective systems of risk management and internal control are designed to identify and manage the risk of failure to achieve business objectives.

Our Risk Management and Internal Control Framework

The Board is responsible for the Group's risk management and internal control systems and for reviewing their effectiveness. The Audit Committee supports the Board in monitoring our risk exposures, the design and operating effectiveness of the underlying risk management, and the internal control systems. The Audit Committee, acting on behalf of the Board, oversees the following process:

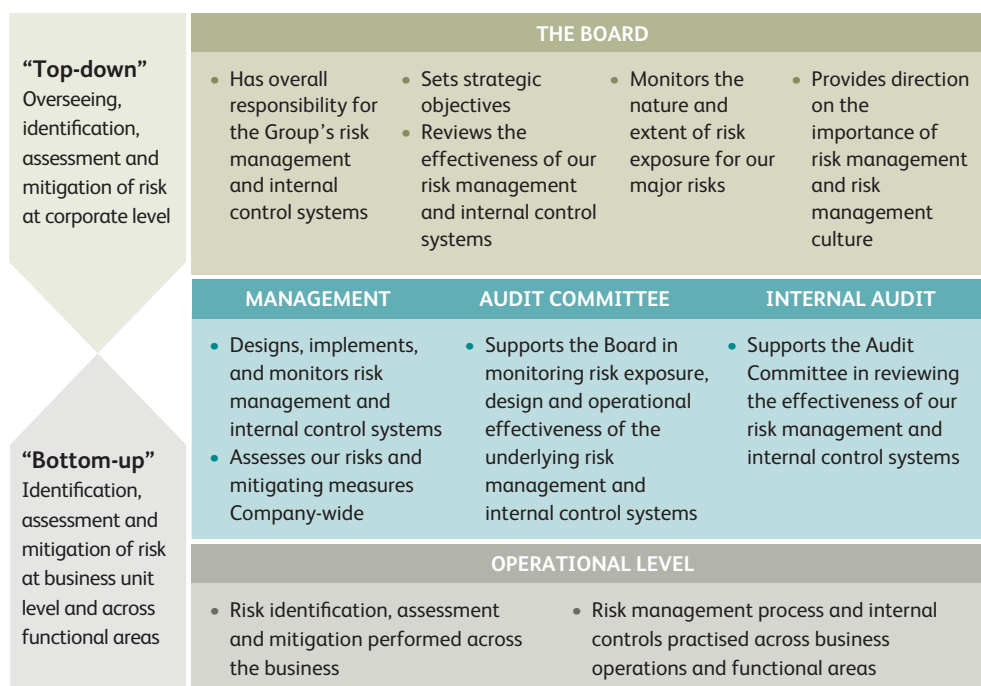
- (i) regular reviews of the principal business risks, and control measures to mitigate, reduce or transfer such risks; the strengths and weaknesses of the overall risk management and internal control systems and action plans to address the weaknesses or to improve the assessment process;
- (ii) regular reviews of the business process and operations reported by Internal Audit, including action plans to address the identified control weaknesses, as well as status updates and monitoring the implementation of audit recommendations; and
- (iii) regular reports by the external auditor of any control issues identified in the course of their work and discussion with the external auditor of the scope of their respective review and findings.

The Audit Committee will then report to the Board after due review of the effectiveness of the Group's risk management and internal control systems.

The Board considers the work and findings of the Audit Committee in forming its own view on the effectiveness of the systems.

(Please also see "Audit Committee Report" on page 121 regarding the Committee's detailed review work, including the forms of "assurance" received from management, external auditor, and internal auditor).

Hysan Risk Management Framework



2016 Review of Risk Management and Internal Control Effectiveness

In respect of the year ended 31 December 2016, the Board, with confirmation from management, considered the risk management and internal control systems effective and adequate. No significant areas of concern that may affect the financial, operational, compliance controls, and risk management functions of the Group have been identified. The systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable and not absolute assurance against material misstatement or loss.

During the review, the Board also considered the resources, qualification/experience of staff of the Group’s internal control, accounting and financial reporting function, and their training and budget were adequate.

Hysan’s Risk Management and Internal Control Model and Continuous Improvement in our Systems

Our risk management and internal control model is based on that set down by the Committee of Sponsoring Organisations of the U.S. Treadway Commission (“COSO”) for internal control, and has five components, namely Control Environment; Risk Assessment; Control Activities; Information and Communication; and Monitoring. In developing our risk management and internal control model based on the COSO principles, we have taken into consideration our organisational structure and the nature of our business activities.

Risk Management and Internal Control Report

Since 2012, we have put in place a phased improvement plan and progressed to further enhance our risk management and internal control systems. The initial phase of the plan focused on adopting a more risk-based (instead of process-based) approach to risk identification and assessment. This approach enriches our ability to analyse risks and respond to opportunities as we pursue our strategic objectives. Management reporting to the Audit Committee has also been enhanced, including the presentation of special reports on selected risk topics.

In the current phase, we aim to further integrate risk management and internal control into our business processes, including into annual budgeting and planning. The COSO framework has been revised, effective December 2013. Instead of treating this as a framework-update exercise, a holistic approach has been adopted, taking into consideration the Company's circumstances, including its ongoing risk management and internal control improvement plan as well as other strategic initiatives. (e.g. corporate social responsibility strategy and reporting). All these further our ultimate objective of making our risk management system a "living" one that is practised on a day-to-day basis by operating units.

- **Control Environment** – this is very important as it sets the tone for risk management and internal control in a company. Hysan is a tightly-knit organisation with around 640 staff members. The actions of management and its demonstrated commitment to effective governance and control are therefore very transparent to all.

We have a strong tradition of good corporate governance and a corporate culture based on sound business ethics and accountability. We have in place a formal Code of Ethics that is communicated to all staff (including new recruits). In 2016, our "whistle-blowing" system was enhanced by adopting a separate "Whistleblowing Policy". The whistleblowers shall raise concerns to a designated independent third party who will report to the Audit Committee. We aim to build risk awareness and control responsibility into our culture and regard them as the foundation of our risk management and internal control systems.

- **Risk Assessment** – we continue to drive improvements to our risk management process and the quality of risk information generated, while at the same time maintaining a simple and practical approach. Instead of setting up a separate risk management department, we seek to have risk management features embedded within our operations (leasing, property management, and project) as well as functional areas (including finance, human resources, IT, and legal). We aim to have a "living" risk management system that is practised on a day-to-day basis by our operating units.

On an annual basis, department heads review and update their risk registers, providing assurances that controls are both embedded and effective within the business.

Management also forms a risk management committee (headed by the top management) which sets the relevant policies and monitors potential weaknesses and action items regularly. It is also responsible for identifying and assessing risks of a more macro and strategic nature, including emerging risks.

This “top-down” approach is complemented by the “bottom-up” aspects and the involvement of operating unit heads in identifying operational risks. These together determine the Group’s major risks. Discussion sessions with all department heads led by the top management have been held, with a view to further enhancing the “participatory” aspect of the overall risk assessment process.

- **Control Activities; Information and Communicating** – our core property leasing and management business involves well-established business processes. Control activities have traditionally been built on top-level reviews; segregation of duties; and physical controls. Over the past few years, we have been formalising and documenting the control processes in policies and procedures. Written policies and procedures with defined limits of delegated authority are in place, which facilitate effective segregation of duties and controls. A greater use of automation (information processing) is also being implemented.

The annual budgeting and planning process is one of our key control activities, which has been refined to take into consideration risk factors. All operating units prepare their respective operating plans pursuant to corporate objectives for consideration. In this process, they are required to identify material risks that may impact the achievement of their business objectives. Action items to mitigate the identified risks are developed for implementation as well as for finalising the budget and business objectives. An annual budget with financial targets, as approved by the Board, provides the foundation for the allocation of resources. Variance analyses are regularly performed, and reported to management and the Board. These help identify deficiencies and enable timely remedial actions to be taken.

Capital expenditures monitoring is also significant given the capital-intensive nature of our property business. Depending on strategic importance, cost / benefit and the size of the projects, detailed analysis of expected risks and returns is submitted to operating unit heads, Chief Financial Officer, Executive Directors or the Board for consideration and approval. The criteria for assessment of financial feasibility are generally based on net present value, payback period and internal rate of return from projected cash flow.

Management conducts an internal control self-assessment annually. All departments / units heads have to complete a relevant control self-assessment questionnaire and confirm to the management that appropriate internal control policies and procedures have been established and properly complied with.

- **Monitoring Activities** – the Board and Audit Committee oversee the process, assisted by our Internal Audit team. Management has enhanced its update reports to Audit Committee on movements on major risks and appropriate mitigating measures. There are three Audit Committee meetings annually, with one meeting substantially devoted to risk management and internal control system.

Further Strengthening of Our Underlying Systems

We have made further progress in strengthening our risk management and internal control system, highlighted as follows:

Control Environment – enhanced legal and regulatory compliance framework	
<ul style="list-style-type: none"> Further strengthened the legal and regulatory compliance framework and strategic foundation for a strong compliance management between legal department, business units, Management, Audit Committee and the Board. 	Continual review and refinement of processes and structures enhance compliance.
Risk Assessment – enhanced monitoring of “emerging risks”	
<ul style="list-style-type: none"> Further strengthened the monitoring of material risks and “emerging risks” (i.e. risks that are new or evolving, which have potentially significant impact even though the likelihood of their happening may not be certain). Management’s Risk Management Committee takes a key role in identifying and tracking these risks. The top management also led further discussions with all department heads. <p>Examples include social-political risks, economic risks, cybersecurity risk etc.</p>	In the context of a fast-changing global and local environment, the monitoring of “emerging risks” will be a focus.
Control Activities – policies and procedures	
<ul style="list-style-type: none"> Identified and implemented new policy to address the changing regulatory environment. For example, company guideline and procedure relating to handle and report data breach is refined and in place. It sets out clear internal procedures for the proper handling and reporting of a data breach incident. This signifies the importance we place on the business practices, which become more important in light of fast-changing regulatory requirements and enhanced stakeholder expectations. Company policy relating to the competition law is in place. Seminar has been held across department to educate and raise awareness of the staff. 	Continual review and refinement of policies and procedures in light of the changing external and internal environment.
Control Activities – Whistleblowing Policy	
<ul style="list-style-type: none"> Enhanced the “whistle-blowing” system by adopting a separate Whistleblowing Policy to allow whistleblowers to raise concerns to a designated independent third party who will report to the Audit Committee. 	Continual review and refinement of risk management and internal control and procedures for handling concerns raised by whistleblowers.
Monitoring – enhanced “management assurance” to the Audit Committee and the Board in their respective reviews	
<ul style="list-style-type: none"> Enhanced management update reports to Audit Committee and the Board on major risks the Group were facing, with deep dive reports on selected topics, e.g. risks management on the redevelopment of Lee Garden Three, safeguards against terrorist attack, etc. To further strengthen management’s “assurance” to Audit Committee and the Board, control self-assessment questionnaires were rolled out across all departments. Department heads were required to certify their departmental controls effectiveness including identifying any control issues. This in turn backs up management’s certification to Audit Committee and the Board. 	Facilitation and enhancement of the work of the Audit Committee and the Board in monitoring our risk exposure.

Way Forward

Embedding a “living” risk management and internal control systems within the day-to-day operation of our operating units is a continuous voyage. We are committed to continually improving our risk management and internal control framework and capabilities of the Group and shall continue on this path, with enhanced integration of risk management and internal control into our business processes.

Our Risk Profile

Our approach for managing risk is underpinned by our understanding of our current risk exposures, and how our risks are changing over time. The following illustrates the nature of our major risks. Further analysis of our strategies is set out in other sections of the Annual Report as indicated below:

Risk	Risk change during 2016	Description of risk change
Impact of macro-economic developments on:		
1. Office Leasing	↑	The office rental market on Hong Kong Island benefited from limited new supply and demand from China financial institutions. However, due to global economic headwinds, there was a drop in the overall demand for office spaces across the market. Also, lower rent in the non-core business areas and the new supply there has driven cost conscious tenants to move out of core areas.
2. Retail Leasing	↑	The retail market was challenging during 2016 as Hong Kong retail sales recorded a decline, resulting from a fall in the number of tourists and a downturn in local sentiment. The weak retail sales led to reluctance by retail tenants to expand their retail enterprises, shop numbers or footprints.
3. Residential Leasing	↑	Reduced demand from expatriates, higher market vacancy and keen competition continued to exert pressure on the luxury residential leasing market and higher vacancy at our property. > For more analysis and mitigating measures, see “The Marketplace” & “Review of Operations”
4. Projects	↔	Main building work for Lee Garden Three is on schedule towards its expected completion date in fourth quarter of 2017. > For more analysis and mitigating measures, see “Review of Operations”
5. Human Resources	↔	The service industry in Hong Kong continues to experience widespread labour shortages. Employers are facing increased competition for skilled personnel, especially experienced front-line staff, to support the Group’s growth strategy. > For more analysis and mitigating measures, see “Responsible Business” section – “Workplace Quality”

Note:

↑ where “inherent risks” (i.e. before taking into consideration mitigating activities) increased

↔ where “inherent risks” remained broadly the same