Business Performance

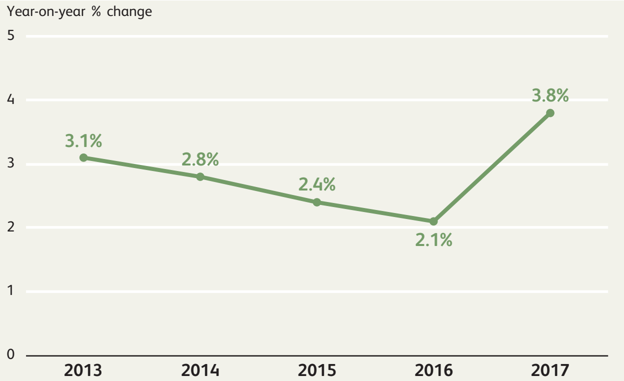
2

The Marketplace

Hong Kong economy

The Hong Kong economy grew by 3.8% year-on-year in 2017. Private consumption expenditure increased by 5.4% supported by favourable employment and earnings. Investment expenditure grew moderately by 4.2%. Exports of goods increased by 5.9% and exports of services rebounded by 3.5% mainly due to a broad-based global economic upturn.

Real Gross Domestic Product*



* In chained (2015) dollars

Source: Census and Statistics Department (data as of March 2018)

Retail

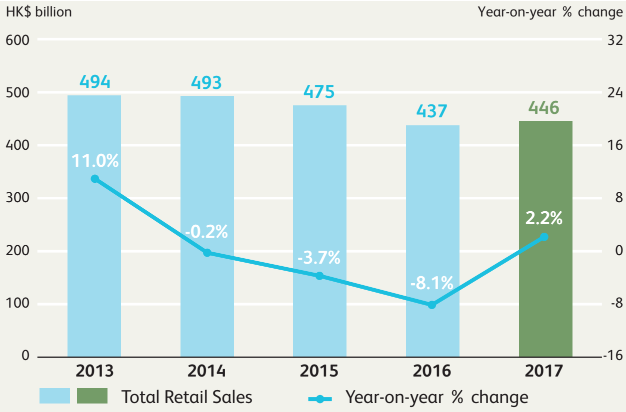
Benefiting from good consumer sentiment, retail sales recorded an annual increase of 2.2% as compared to the previous year. Key contributors were the medicines and cosmetics, and luxury products sectors.

A 3.9% increase in Mainland China visitors during the year was one of the core factors in the overall retail increase. Local consumers also contributed to the retail market upturn as shown by the notably increase in private consumption expenditure.

	Categories	2017 growth rate
Key dropping categories	Electrical goods and photographic equipment	- 9.0%
	Footwear, allied products and other clothing accessories	- 2.1%
Growing categories	Medicines and Cosmetics	+ 5.5%
	Jewellery, watches and clocks, and valuable gifts	+ 5.2%

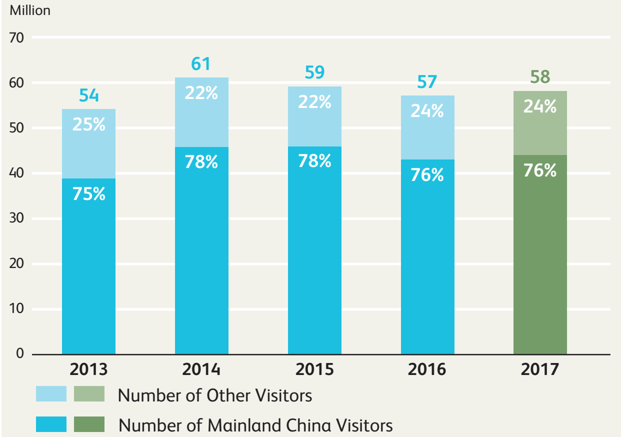
Source: Census and Statistics Department (data as of March 2018)

Hong Kong Total Retail Sales



Source: Census and Statistics Department (data as of March 2018)

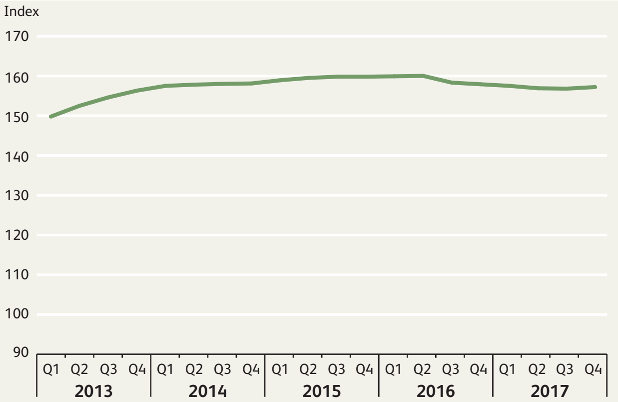
Total Number of Visitors



Source: Hong Kong Tourism Board (data as of March 2018)

According to Jones Lang LaSalle, rents for retail premises in prime shopping centers picked up marginally in the fourth quarter but still dropped mildly by 0.4% for the full year in 2017.

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



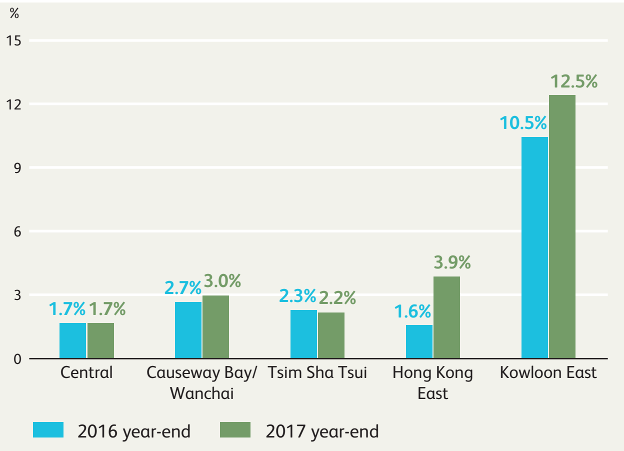
Source: Jones Lang LaSalle (data as of December 2017)

Office

Rents in the Grade “A” office market recorded good growth in general. The primary growth driver was the demand from Mainland China firms, and co-working operators. Mainland China companies took up about 48% of new lettings in Central during the year. However, some sub-markets such as Kowloon East, experienced a decline due to mounting supply pressure.

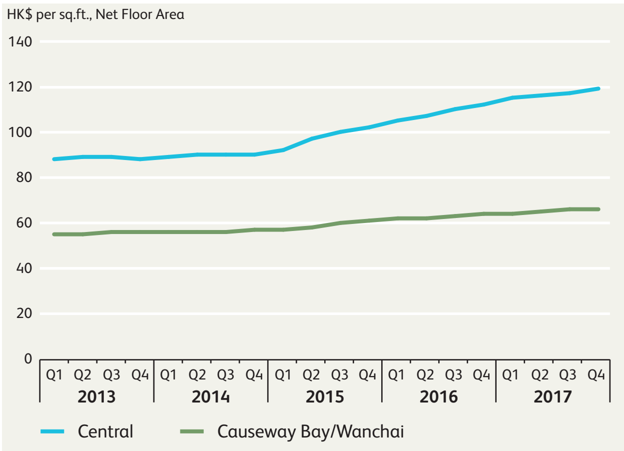
As at the end of December 2017, Kowloon East had a double digit vacancy while Central’s vacancy rate remained low at 1.7%. The strong demand in Central pushed rentals upwards to $118.6 per sq. feet in December 2017.

Grade “A” Office Vacancy Rate in 2016 and 2017



Source: Jones Lang LaSalle (data as of December 2017)

Grade “A” Office Monthly Net Effective Rental Value



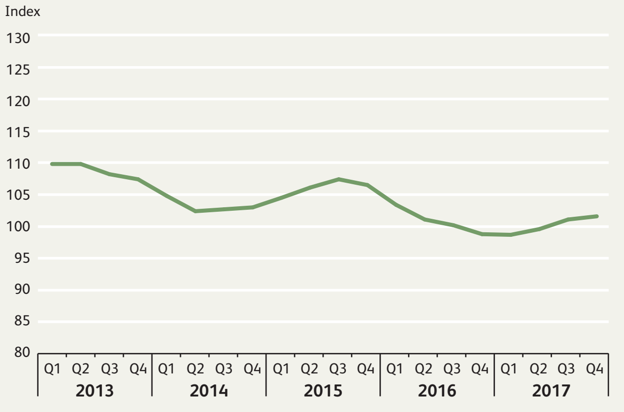
Source: Jones Lang LaSalle (data as of December 2017)

Luxury Residential

Luxury residential rents began to pick up in 2017. Positive business outlook has supported leasing demand.

According to Jones Lang LaSalle, luxury residential rents increased 2.9% for the full year in 2017.

Luxury Residential Rental Index (2009 Q4=100)



Source: Jones Lang LaSalle (data as of December 2017)

Management's Discussion and Analysis

Hysan's portfolio of retail, office and residential investment properties has a total gross floor area of approximately 4.1 million square feet. This does not include the newly completed Lee Garden Three mixed-use commercial building, which has a gross floor area of around 467,000 square feet.

Strategy

The Group is committed to seeking a steady growth of return for our shareholders. The vast majority of our properties are located in Hong Kong's Causeway Bay, and the area will remain our home base and the core of our focus. The Group also seeks investment opportunities beyond our core. One recent project is a joint-venture residential project in Hong Kong's Tai Po.

We enhance the value of our properties through refurbishing, repositioning, redevelopment and other means of portfolio management. We actively seek new investment opportunities with an aim to enhance long-term value for shareholders. We also strive to curate a unique community in the Lee Gardens area of Causeway Bay for our tenants and other stakeholders. With sound financial management underpinning everything we do, we execute our work through a dedicated team of professionals well versed in different aspects of the real estate industry.

Review of Results

The Group saw a slight turnover increase of 0.4% to HK$3,548 million, from HK$3,535 million in 2016.

The turnover of each sector is shown as below:

	2017 HK$ million	2016 HK$ million	Change %
Retail sector	**1,925**	1,969	-2.2
Office sector	**1,359**	1,292	+5.2
Residential sector	**264**	274	-3.6
	3,548	3,535	+0.4

Recurring Underlying Profit, our key core leasing business performance indicator, experienced a slight decline of 0.8% to HK$2,349 million (2016: HK$2,369 million). This reflected the small growth in turnover as a result of the market conditions, as well as the increase in expenses for Lee Garden Three after its completion. Basic earnings per share based on Recurring Underlying Profit were HK224.68 cents (2016: HK226.29 cents), down 0.7%.

Underlying Profit, which excludes unrealised changes in fair value of investment properties, was HK$2,491 million, increased by 5.1% from HK$2,369 million in 2016. This principally reflected a one-off compensation of HK$142 million (2016: nil) (net of taxation and non-controlling interests' shares) from a retail tenant during the year. Basic earnings per share based on Underlying Profit correspondingly rose to HK238.26 cents (2016: HK226.29 cents), up 5.3%.

The Group's Reported Profit for 2017 was HK$3,636 million (2016: HK$1,218 million). This reflected a fair value gain of HK$853 million (2016: fair value loss of HK$1,187 million) on the Group's investment properties' valuation. As at year-end 2017, the external valuation of the Group's investment property portfolio increased by 4.1% to HK$72,470 million (2016: HK$69,633 million). This reflected a combination of factors: a generally positive office rental outlook; a number of asset enhancement works completed; a higher valuation for the completed Lee Garden Three; and an improving retail outlook. The capitalisation rates used in valuing each portfolio remained unchanged from those used as at 31 December 2016.

	2017 HK$ million	2016 HK$ million	Change %
Recurring Underlying Profit	**2,349**	2,369	-0.8
One-off early surrender compensation income (net of effect of taxation and non-controlling interests' shares)	**142**	–	n/m
Underlying Profit	**2,491**	2,369	+5.1
Fair value gain (loss) on investment properties located in			
– Hong Kong (net of effect of non-controlling interests' shares)	**1,106**	(1,157)	n/m
– Shanghai*	**11**	6	+83.3
Imputed interest income on interest-free loan to a joint venture	**28**	–	n/m
Reported Profit	**3,636**	1,218	n/m

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

n/m: not meaningful

Review of Operations

As at 31 December 2017, excluding the new Lee Garden Three, about 83% of the Group's investment properties by gross floor area were retail and office properties in Causeway Bay. The remaining 17% was represented by residential properties in the Mid-Levels.

In terms of turnover contributions by the different business portfolios, about 54% was attributable to retail, 38% 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. Cost effectiveness is assessed by the Group's management using the property expenses ratio (as a percentage of turnover).

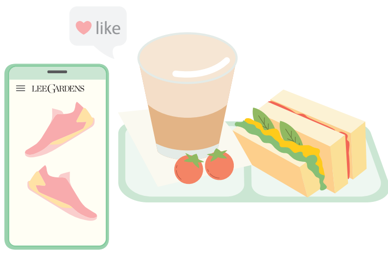
Key Performance Indicators	Definition	Business Performance
Turnover Growth	Rental revenue in 2017 vs that in 2016	Retail: -2.2% (2016 vs 2015: +3.5%) Office: +5.2% (2016 vs 2015: +3.9%) Residential: -3.6% (2016 vs 2015: -3.9%)
Occupancy Rate**	Percentage of total area leased*/ total lettable area* of each portfolio at year end	Retail: 97% (2016: 99%) Office: 96% (2016: 96%) Residential: 75% (2016: 82%)
Property Expenses Ratio	Property expenses divided by turnover	12.7% (2016: 12.1%)

* Source of underlying data: Internal company data

** The retail and office occupancy percentages did not include Lee Garden Three which was completed in Mid-December 2017. This definition is applied to the whole "Management's Discussion and Analysis" section.

Note: No changes have been made to the source of data or calculation methods used compared to 2016.

RETAIL PORTFOLIO



The Group's retail portfolio turnover saw a decline of 2.2% to HK$1,925 million (2016: HK$1,969 million), which included turnover rent of HK$48 million (2016: HK$46 million). With an ongoing tenant mix adjustment, some shop spaces experienced positive rental reversion while others saw negative reversion in rental renewals, reviews and new lettings.

The portfolio's occupancy was 97% as at 31 December 2017 (31 December 2016: 99%).

Foot traffic for Hysan's retail portfolio decreased by around 5% in 2017, as compared to 2016. This was due mainly to major renovation and fit out works for a number of new tenants. Some improvement in footfall was seen towards the end of the year.

The estimated overall tenant sales within the portfolio experienced a single-digit percentage increase, as compared to 2016. This compared well to Hong Kong's overall retail sales in 2017.

Newly joined tenants in 2017 included Brunello Cucinelli, Zeiss Vision Center by Puyi Optical, Cha Ling and i.t. blue block. The latter in particular reinforced Hysan Place's position as Hong Kong's top fashionable shopping venue. Our portfolio also welcomed a number of new food and beverage establishments to further add to our reputation as a foodie destination. BRICK LANE, The PHO, and IPPUDO were among the eateries that joined, as well as FLIPPER'S, the popular pancake restaurant operating out of i.t. blue block. In early 2018, we welcomed 10 Shanghai and Sushi Ta-ke.

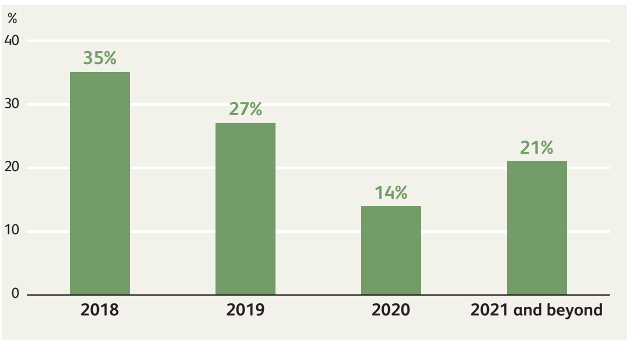
2017 saw a number of show-stopping events taking place at Hysan's portfolio. The Cathay Pacific/HSBC Rugby Sevens Fan Walk in April attracted much attention both from the sport's hardcore fans who travelled to Hong Kong from different parts of the world, as well as from casual local visitors who previously may have had less exposure to this international sporting event. The dining and shopping promotions that complemented the weekend event brought customers and sales to the restaurants and shops within the Hysan portfolio. The weekend's street carnival on Hysan Avenue and Yun Ping Road established Lee Gardens as a true destination in the hearts and minds of thousands of international visitors.

The summer's programme in cooperation with eslite was another highlight attracting considerable attention. The lifestyle theme permeated the month-long event with books, a selection of coffees and even cassette tapes playing major roles. The winter holiday period saw Christmas markets in the Lee Gardens area, with a number of stalls hosted by renowned celebrities. Giant baubles, adopted by charity donors, adorned the malls. Both these events successfully reflected our commitment to providing interesting content and entertainment for all those who come and shop in our spaces.

We made substantial use of social media to help promote our events and activities, as well as our range of special offers provided throughout the year. On the topic of promotions, we strengthened our cooperation with a number of Mainland Chinese social media organisations to push our messages into the Mainland market. We also worked closely on promotional projects with banks and credit card operators that are popular with Mainland visitors.

2017 was a successful year for our two loyalty programmes: the VIP Club Avenue, and the general shoppers' Lee Gardens Plus. For Club Avenue, the number of members saw a low double-digit percentage growth, as compared to 2016, while sales also experienced a similar level of percentage growth. Tenant referral and collaboration were key to our success. For Lee Gardens Plus, the number of members grew in multiples. More attractive promotional offers and a simplified registration process helped to ensure significant membership growth.

Retail Lease Expiry Profile by Area Occupied (As at 31 December 2017)



OFFICE PORTFOLIO

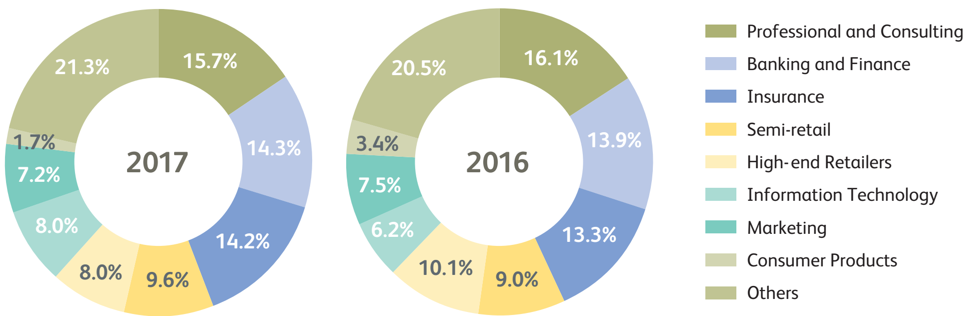
The Group's office portfolio turnover increased by 5.2% to HK$1,359 million (2016: HK$1,292 million). The results reflected overall positive rental reversion on renewals, reviews and new lettings.

The office portfolio occupancy was 96% as at 31 December 2017 (31 December 2016: 96%).

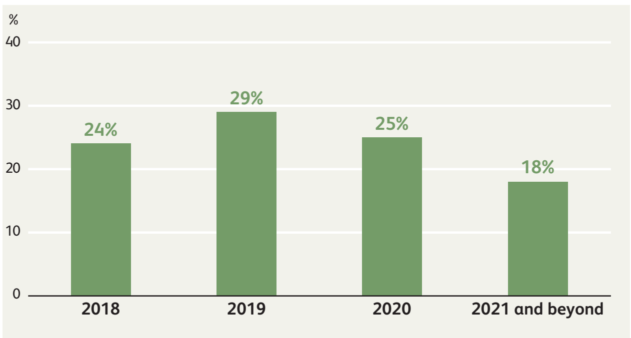
Causeway Bay remained one of the most sought after areas for multinational and local corporations seeking prestige, convenience and good value for money. Lee Garden Three's pre-leasing activities slowed down somewhat in the second half of 2017, but close to 55% of its office space was committed for rental. Kim Eng Securities (HK) Ltd, a subsidiary of Maybank Group was the building's first moved-in tenant, while Spaces, a renowned full service co-working environment provider, was among the in-coming tenants. Both workers and visitors to the building would find it easy to park, since more than 200 spaces were added upon the completion of the building.

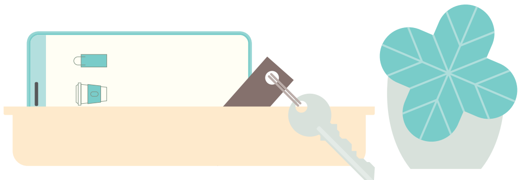
Professional and Consulting remained the sector taking up the most space in Hysan's office portfolio. Banking and Finance, Insurance and Semi-Retail took up the second, third and fourth spots. These four sectors combined to occupy around 50% of our lettable floor area. Reflecting a diverse tenant mix, no category took up more than 20% of the total lettable area.

Office Tenant Profile by Area Occupied as at Year-end



Office Lease Expiry Profile by Area Occupied (As at 31 December 2017)





RESIDENTIAL PORTFOLIO

Hysan's residential portfolio, comprising mainly the units in Kennedy Road's Bamboo Grove, experienced a 3.6% turnover decrease to HK$264 million (2016: HK$274 million). The sector's occupancy was 75% as at 31 December 2017 (31 December 2016: 82%). The decline in occupancy was due to more units being renovated, as well as changes in demand by expatriates.

The rental reversion was overall positive on renewals, reviews and new lettings.

LEE GARDEN THREE PROJECT

The construction project was completed in December 2017, upon the issuance of the Occupation Permit. Lee Garden Three is a commercial building that promotes environmental friendliness and work-life balance with a retail podium, a Roof Top Garden, a Sky Garden with a 100 metre long running track, as well as a range of dining hotspots, all complementing the lifestyle elements in the Lee Gardens portfolio. The first office tenants have already moved in, and three levels of parking spaces are already open for use by tenants and the visiting public.

TAI PO LO FAI ROAD PROJECT

Design development of our low density residential development project at Tai Po is making good progress. Various statutory submissions are ongoing. Site formation and foundation works will commence in Q2 2018.

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 4.9% to HK$449 million (2016: HK$428 million), mainly due to higher marketing expenses to enhance shopping attractions; increased life-cycle repairs and maintenance costs; agency fees to external leasing agents for Lee Garden Three; and offsetting lower utility costs as a result of tariff reduction. As the increase in property expenses is more than the relevant increase in turnover, property expenses to turnover ratio thus increased slightly from 12.1% to 12.7% as compared to 2016.

Administrative expenses increased by 12.8% to HK$247 million (2016: HK$219 million). This reflected human resources upskilling and the filling of previously vacant positions.

FINANCE COSTS

Finance costs, after capitalisation of HK$51 million (2016: HK$14 million) interest expenses and related borrowing costs referable to the construction costs of Lee Garden Three, recorded a decrease of 11.2% to HK$158 million (2016: HK$178 million). If the capitalised interest expenses and related borrowing costs were included, the Group's finance costs in 2017 would have been HK$209 million, an increase of 8.9% from HK$192 million in 2016. The increase was attributable to the higher average debt level in 2017 as compared to 2016 after debt repayments in both years. The Group's average cost of finance in 2017 was 3.4%, lower than the 3.8% reported for 2016 due to the increase in interest expenses, which were relatively lower than the percentage increase in average debt level during 2017.

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 gain on investment properties (excluding capital expenditure spent on the Group's investment properties) of HK$853 million (2016: fair value loss of HK$1,187 million) was recognised in the Group's consolidated statement of profit or loss for the year. This figure reflected a combination of factors: a generally positive office rental outlook; a number of asset enhancement works completed; as well as a higher valuation for the completed Lee Garden Three and an improving retail outlook.

As at 31 December 2017, the Group's investment property portfolio (including property under redevelopment) was HK$72,470 million, an increase of 4.1% from HK$69,633 million as at 31 December 2016. This valuation was carried out by Knight Frank Petty Limited, an independent professional valuer, on the basis of open market value. The capitalisation rates used in valuing each portfolio remained unchanged from those used as at 31 December 2016.

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

	2017 HK$ million	2016 HK$ million	Change %
Retail	**33,188**	33,082	+0.3
Office	**31,325**	23,832	+31.4
Residential	**7,957**	7,859	+1.2
Lee Garden Three*	**–**	4,860	n/m
	72,470	69,633	+4.1

* Lee Garden Three's construction works were completed during the year ended 31 December 2017

n/m: not meaningful

INVESTMENT IN AN ASSOCIATE

The Group's share of results of an associate decreased to HK$220 million (2016: HK$237 million). This decline mainly reflected the impact from renovation of the Shanghai Grand Gateway project, of which the Group owns 24.7%. As at 31 December 2017, 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, amounted to HK$11 million (2016: HK$6 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 measure helped to preserve the Group's liquidity and to enhance interest yields.

Excluding recognition of imputed interest income on the non-current interest-free loan to a joint venture company for residential sites' development in Tai Po of HK$28 million (2016: nil), like-for-like interest income decreased by 18.0% to HK$41 million (2016: HK$50 million). This figure mainly reflected a lower average investment amount after the payment of the construction costs of Lee Garden Three.

Cash Flow

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

	2017 HK$ million	2016 HK$ million	Change %
Operating cash inflow	**2,900**	3,326	-12.8
Investments	**1,020**	1,331	-23.4
Net repayment from (advance to) a joint venture company	**935**	(2,036)	n/m
Financing	**(151)**	1,427	n/m
Interest and taxation	**(566)**	(523)	+8.2
Dividends paid and proceeds on exercise of options	**(1,524)**	(1,500)	+1.6
Capital expenditure	**(1,947)**	(847)	n/m
Consideration for shares repurchased	**–**	(395)	n/m
Net cash inflow	**667**	783	-14.8

n/m: not meaningful

The Group's net operating cash inflow was HK$2,900 million (2016: HK$3,326 million), HK$426 million lower than in 2016, reflecting a one-off compensation received from a tenant during 2016.

Net cash from investments was HK$1,020 million (2016: HK$1,331 million), mainly attributable to reduction in investments in time deposits with longer tenors.

Net repayment from a joint venture company was HK$935 million after completion of project financing on land acquisition costs during the year. In 2016, cash in advance to a joint venture company was HK$2,036 million for the payment of land acquisition costs.

Net cash used in financing was HK$151 million after net repayment during the year. In 2016, net cash from financing was HK$1,427 million. This principally reflected new bank loans of HK$1,680 million for the payment of land acquisition costs, which offset the repayment of a HK$250 million bank loan during 2016.

The Group paid dividends of HK$1,411 million (2016: HK$1,394 million), being the 2016 second interim dividend of HK109 cents per share (2015: HK107 cents) and the 2017 first interim dividend of HK26 cents (2016: HK26 cents) per share.

The Group repurchased 12.59 million of its own shares in 2016, at an aggregate consideration of HK$395 million. The average purchase price per share was HK$31.24.

CAPITAL EXPENDITURE AND MANAGEMENT

The Group is committed to enhancing the asset value of our investment property portfolio through selective asset enhancement and redevelopment. The Group has also established a portfolio-wide whole-life cycle maintenance programme as part of our ongoing strategy to pro-actively implement preventive maintenance activities. Total cash outlay of capital expenditure during the year was HK$1,947 million (2016: HK$847 million), including the payment of the construction costs of Lee Garden Three.

Treasury Policy

MARKET HIGHLIGHTS

2017 was a year of global growth recovery, driven by synchronised global expansion. On the back of the falling U.S. unemployment rate, improving GDP growth and low inflation, the Federal Reserve raised the federal funds rate by 25 basis points on three occasions in 2017. The Federal Reserve has further stated that it will continue to withdraw liquidity by gradually increasing the federal funds rate and tapering its balance sheet in the coming period. Under the currency board system, Hong Kong interest rates rise in line with the Federal Reserve's progressive normalisation of monetary policy. HKD Hibor rates rose during the last quarter of 2017 but the differential with the U.S. Libor rates has remained wide as a result of rising U.S. interest rates and ample liquidity in Hong Kong. Asia also performed well in 2017 owing to benign U.S. inflation and the strength of commodity prices. China also witnessed robust growth in 2017. However, the rate of growth has slowed due to the tightening of financial and environmental regulations.

Although global economic growth continues, concerns remain for the year ahead. Geopolitical events such as those related to North Korea could impact sentiment and destabilise the market. A more marked slowdown in the growth of China's economy may also impact the rest of the world. It is therefore important for the Group to continue our policy of prudent financial management.

CAPITAL STRUCTURE MANAGEMENT

Despite the interest rate tightening in the U.S., there was ample liquidity in the banking system of Hong Kong in 2017. The credit margin of bank loans for companies with investment grade credit ratings saw a modest decline. The 3-month HKD Hibor increased from around 1% at the end of 2016 to around 1.3% at the end of 2017.

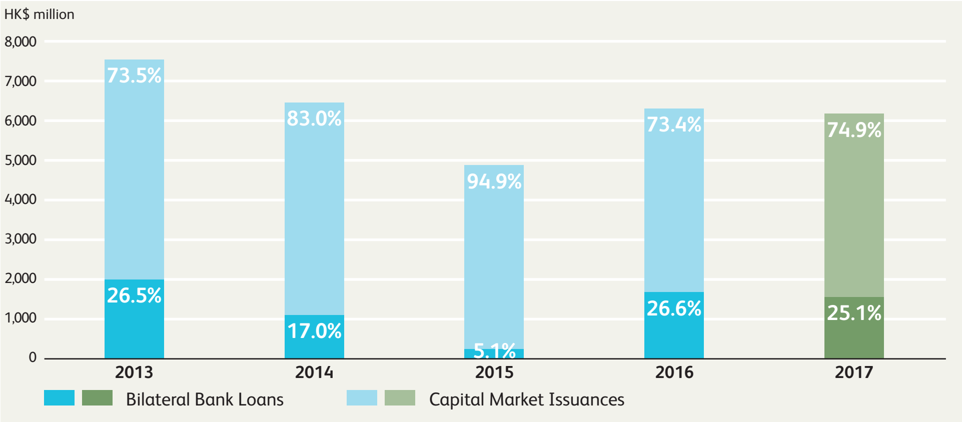
During 2017, the Group arranged HK$1,500 million five-year bank facilities on competitive terms. The outstanding gross debt[1] of the Group was HK$6,176 million (2016: HK$6,305 million) at year-end 2017, a decrease of HK$129 million compared with 2016. All the outstanding borrowings are on an unsecured basis.

The Group always strives to lower the borrowing margin, to diversify funding sources and to maintain a suitable maturity profile relative to the overall use of funds. Because of the repayment of bank loans in 2017, debts sourced from the capital market increased to 74.9% (2016: 73.4%) at year-end. The Group continued to maintain long-term relationships with a number of local and overseas banks in order to diversify funding sources. At year-end 2017, 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 2017. 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 2017, the book value of the outstanding debt of the Group was HK$6,185 million (31 December 2016: HK$6,293 million).

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 2017, the average maturity of the debt portfolio was about 4.3 years (2016: 4.3 years), of which about HK$150 million or 2.4% of the outstanding gross debt will be due in less than one year. Given that the Group had cash and bank deposits of HK$2,662 million, the Group is able to meet the debt repayment in 2018 without much refinancing pressure.

The graph below shows the debt maturity profile of the Group at year-end 2017 and 2016.

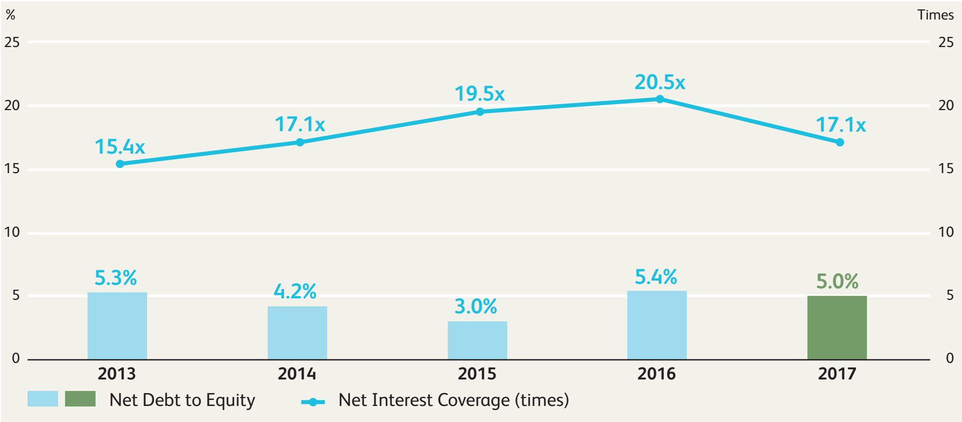
Debt Maturity Profile at 2016 and 2017 Year-end

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 ratio[1], decreased from 5.4% at year-end of 2016 to 5.0% at year-end of 2017, mainly due to debt repayment in 2017. The Group's Net Interest Coverage[2] slightly reduced to 17.1 times for 2017 (2016: 20.5 times) mainly due to the drawdown of bank loans during 2016. The low gearing and strong ability to meet interest payments reflected the Group's resilience and capability to raise further debt if necessary.

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 2017, the Group had cash and bank deposits totalling about HK$2,662 million (2016: HK$2,630 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$737 million (2016: HK$1,155 million) in debt securities.

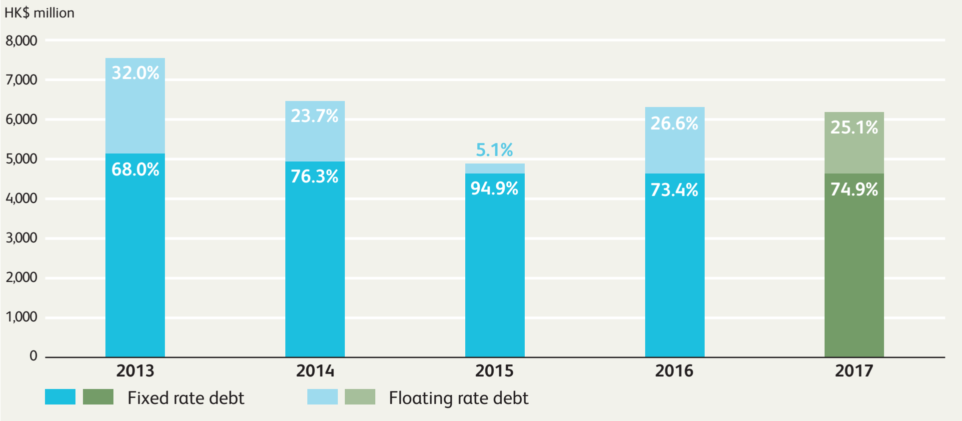
Further liquidity, if needed, is available from the undrawn committed facilities offered by the Group's relationship banks. These facilities, amounted to HK$950 million at year-end 2017 (2016: HK$500 million), essentially allowing the Group to obtain additional liquidity as the need arises.

The fixed debt ratio increased to 74.9% at year-end 2017 from 73.4% at year-end 2016. As the U.S. has entered the interest rate normalisation cycle, the Group believes that interest rates will continue to rise in the coming years. We expect that the current fixed debt ratio will allow the Group to weather the risk of an interest rate hike cycle.

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.

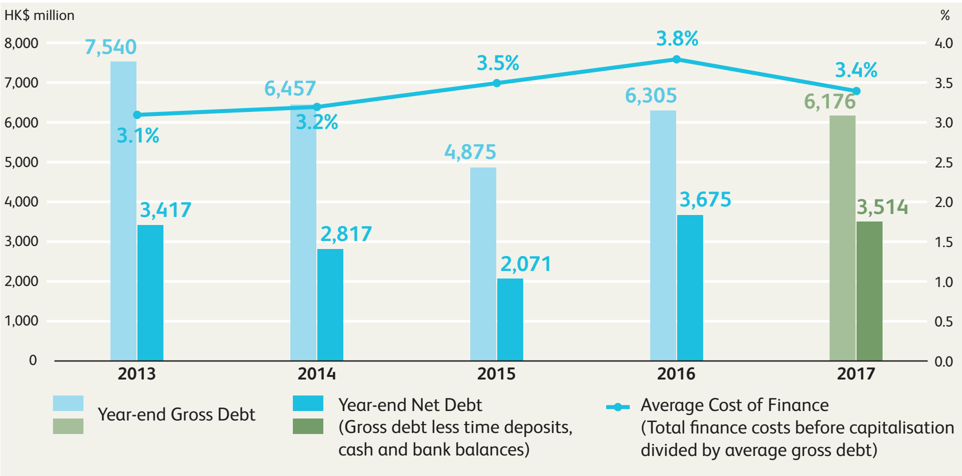
The diagram below shows the fixed rate debt and floating rate debt portions in the past five years.

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 into to effectively convert the borrowing into Hong Kong dollars.

On the investment side, as at 31 December 2017, the Group's outstanding foreign currency balances in cash, time deposits and debt securities amounted to US$128 million (2016: US$180 million), of which US$70 million (2016: US$98 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$3,779 million (2016: HK$3,497 million) or 4.6% (2016: 4.4%) of total assets.

USE OF DERIVATIVES

As at 31 December 2017, 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 to 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

Responsibility for risk management is shared among the Board of Directors and the management of the Group. The Board has the overall responsibility of reviewing and maintaining sound and effective risk management and internal control systems. Management's role is to design and implement these systems, and report to the Board and Audit Committee on the risks identified and how they are managed which are essential for the Group to achieve its business objectives.

Our Risk Management and Internal Control Framework

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. Acting on behalf of the Board, it oversees the following process on a regular basis:

(i) Reviewing the principal business risks and control measures in order 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 improve the assessment process;

(ii) Reviewing 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) Reporting 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 its findings to the Board, which then consider these findings in forming its own view on the effectiveness of the Group's risk management and internal control systems.

Please also see the "Audit Committee Report" from pages 86 to 89 regarding the Committee's detailed review work, including the forms of assurance received from management, the external auditor and internal auditor.

Hysan's Top-Down/Bottom-Up Risk Management Framework

"Top-down"
Overseeing, identifying, assessing, and mitigating risk at corporate level

THE BOARD

- Has overall responsibility for the Group's risk management and internal control systems
- Sets strategic objectives
- Reviews the effectiveness of our risk management and internal control systems
- Monitors the nature and extent of risk exposure for our major risks
- Provides direction on the importance of risk management and risk management culture

RISK MANAGEMENT COMMITTEE AND MANAGEMENT	AUDIT COMMITTEE	INTERNAL AUDIT
• Designs, implements, and monitors risk management and internal control systems • Assesses our risks and mitigating measures Company-wide	• Supports the Board in monitoring risk exposure, design and operational effectiveness of the underlying risk management and internal control systems	• Supports the Audit Committee in reviewing the effectiveness of our risk management and internal control systems

OPERATIONAL LEVEL

- Risk identification, assessment and mitigation performed across the business
- Risk management process and internal controls practised across business operations and functional areas

"Bottom-up"
Overseeing, identifying, assessing, and mitigating risk at business unit level and across functional areas

2017 Review of Risk Management and Internal Control Effectiveness

In respect of the year ended 31 December 2017, the Board, with confirmation from the Chief Operating Officer, Chief Financial Officer, Head of Internal Audit and Company Secretary, considered the risk management and internal control systems to be effective and adequate. No significant areas of concern that may affect the financial, operational, compliance controls, internal audit, risk management and internal controls functions of the Group were identified. The risk management and internal control systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable, not absolute, assurance against material misstatement or loss.

During the review, the Board also considered the resources, qualifications/experience of staff of the Group's internal audit, accounting and financial reporting functions and their training and budgets were adequate.

Our Risk Management and Internal Control Model

Our risk management and internal control model is based on that of the Committee of Sponsoring Organisations of the U.S. Treadway Commission ("COSO") for internal control, but with due consideration given to our organisational structure and business nature.

The COSO model has five components and how the model fit in to our operational and control environment is described as follows:

- **Control Environment** – this sets the tone for risk management and internal control. As Hysan is a tightly-knit organisation, the actions of management and its commitment to effective governance are 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, we adopted a separate Whistleblowing Policy, under which whistle blowers can raise concerns to a designated independent third party who will report to the Audit Committee. Our overall aim is to build risk awareness and control responsibility into our culture, which are the foundation of our risk management and internal control systems.

- **Risk Assessment** – we continue to improve our risk management process and the quality of information generated, while maintaining a simple and practical approach. Instead of setting up a separate risk management department, we seek to embed risk management into our operations (retail, office, residential, property management & technical services, projects, marketing and development & investment) and functional areas (including finance, human resources, IT, legal, secretarial and corporate communications).

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

  Management is part of a risk management committee (consists of Executive Director(s), Chief Operating Officer, Chief Financial Officer, Head of Legal and Head of Internal Audit), which sets relevant policies and monitors potential weaknesses and action items regularly. This committee 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 a bottom-up approach in which operating unit heads identify operational risks. Together, these determine the Group's major risks. Discussion sessions with all department heads further enhance the participatory aspect of the overall risk assessment process.

- **Control Activities and 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. These control policies are now formalised as written policies and procedures, with defined limits of delegated authority and segregated duties and controls. A greater use of automation (information processing) is also being implemented.

  The annual budgeting and planning process, one of our key control activities, has been refined to take into consideration risk factors. In preparing their respective plans, all operating units are required to identify material risks that may have an impact on the achievement of their business objectives. Action items to mitigate identified risks are developed for implementation as well as for finalising the budget and business objectives. Variance analyses are regularly performed and reported to management and the Board, which help to identify deficiencies for timely remedial actions to be taken.

Another significant control activity is the monitoring of project expenditures, as they are a particularly capital-intensive aspect of our property business. For each project, a detailed analysis of expected risks and returns is submitted to the operating unit heads, Chief Operating Officer, Chief Financial Officer, Executive Director(s) or the Board for approval. Criteria used to assess financial feasibility are generally based on net present value, payback period and internal rate of return from projected cash flow.

Management also conducts an internal control self-assessment annually. All department/unit heads must complete a relevant control self-assessment questionnaire and confirm with management that appropriate internal control policies and procedures have been established and properly complied with.

- **Monitoring Activities** – the Board and Audit Committee oversee the control process, assisted by our Internal Audit team. Management provides update reports to the Audit Committee on major risks and appropriate mitigating measures. Among the three Audit Committee meetings held annually, one is substantially given over to the risk management and internal control systems.

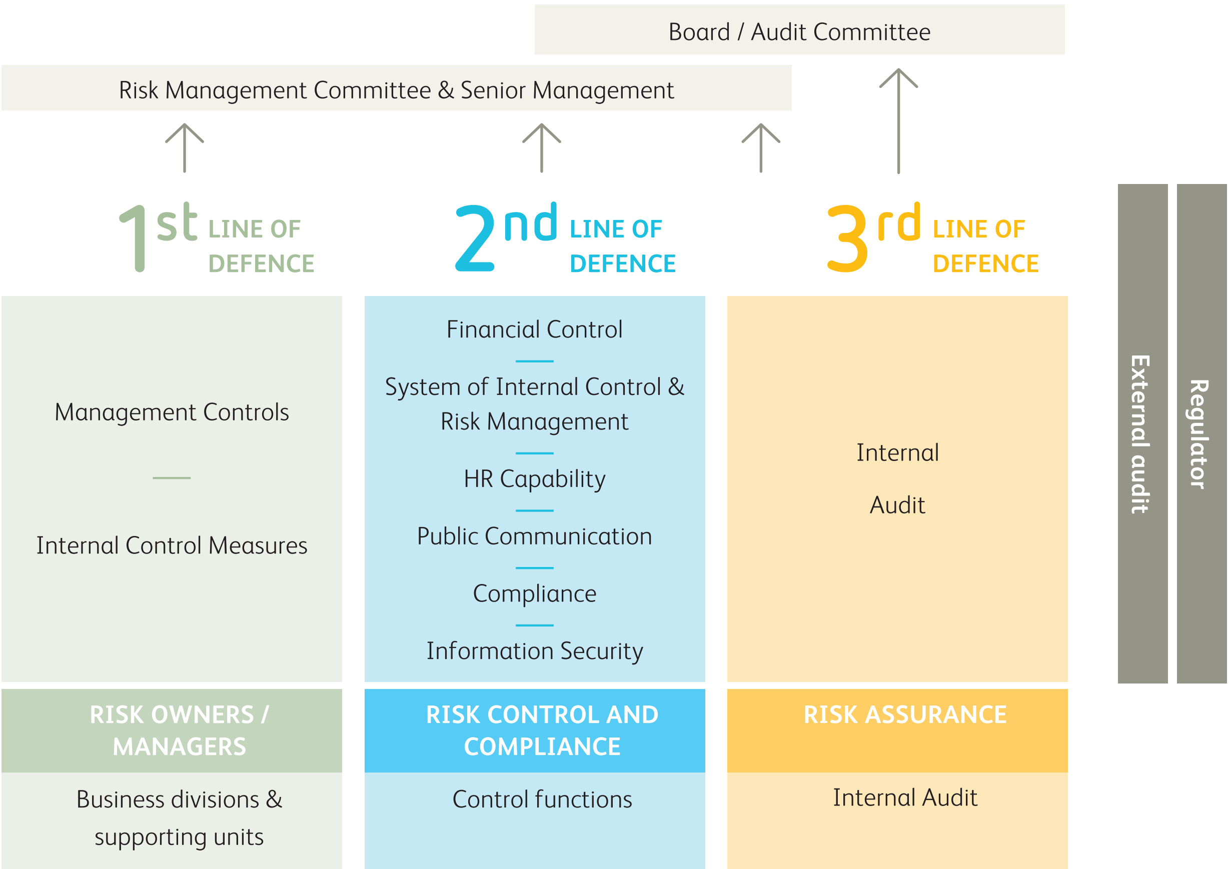
Strengthening our Underlying Systems

Since 2012, we have been progressively making improvements to our risk management and internal control systems. The initial phase focused on adopting a more risk-based — rather than process-based — approach to risk identification and assessment. This new 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.

Our goal is to further integrate risk management and internal control into our business processes, including annual budgeting and planning. In December 2013, we revised the COSO framework to adopt a holistic approach to risk management, taking into consideration the Company's circumstances, including its ongoing risk management and internal control improvement plan as well as strategic initiatives such as corporate social responsibility. Ultimately, our objective is to make risk management a "living" process that is practised on a day-to-day basis by operating units.

HYSAN'S "THREE LINES OF DEFENCE" MODEL

Clear responsibilities and robust controls are vital to help manage risks and build trust. During the year 2017, we further reinforced our risk governance structure by adopting a "Three Lines of Defence" model to address how specific duties related to risk and control could be assigned and coordinated within the Group. It reinforces Hysan's risk management capabilities and compliance culture across all divisions and functions.



The model aims to reinforce Hysan's risk management capabilities and compliance culture throughout the Group. The responsibilities of each of the defence lines are as follows:

	Relevant units	Responsibilities
First Line	Business and supporting units	Ultimately accountable for all risks and controls in all business processes
Second Line	Corporate oversight and control functions	Responsible for the Group's policy framework and independent risk assessment
Third Line	Group internal audit	Responsible for ensuring independent and objective assurance on the effectiveness of risk management, internal controls and governance processes

HYSAN'S REGULATORY COMPLIANCE AND GOVERNANCE FRAMEWORK

The Board, supported by the Audit Committee, shall have overall regulatory compliance authority in all matters. During the year 2017, we have reviewed our regulatory compliance and governance framework taking the house of governance initiative. This forms a central part of our commitment to high standard of internal control governance.

OUR PAST EFFORTS IN ENHANCING THE INTERNAL CONTROL ENVIRONMENT AND ACTIVITIES

In addition to the above major enhancements during the year, the following are examples of the improvements we have made over the past few years to strengthen our risk management and internal control system:

Control Environment – policy of compliance	
• Policy of compliance together with the compliance framework, key owners of compliance and a non-compliance checklist developed and enhanced. General Counsel of the Group presented the "Risk Management and Internal Control Framework" to the senior management and department heads.	Ongoing review/ refinement of processes and structures to enhance compliance.
Risk Assessment – enhanced monitoring of "emerging risks"	
• Strengthened the monitoring of material risks and "emerging risks", i.e. new or evolving risks with potential significant impact, such as socio-political, economic or cybersecurity risks. The Risk Management Committee plays a key role in identifying and tracking these risks, with top management leading discussions with all department heads.	In the context of a fast-changing global and local environment, the monitoring of "emerging risks" will be a focus.
Control Activities – procedures for monitoring connected transactions	
• Automation of exceptional report for monitoring connected transactions has been reviewed and enhanced. Connected transactions seminars had been conducted for all departments by General Counsel.	Continual review and refinement of policies and procedures in the changing external and internal environment.
Control Activities – internal controls and policies	
• Enhanced the procedure for handling and reporting a data breach (jointly developed by legal and IT departments) to support compliance of Personal Data (Privacy) Ordinance. • A new procurement manual has been developed to tighten the internal controls, in particular, the setup of Tender Committee and the segregation of duties in handling technical and financial matters during tendering. • Regular trainings and education across the Group during the year, including leasing, intellectual property, etc.	Continual review and refinement of risk management and internal controls for handling concerns raised by whistle blowers.
Monitoring Activities – enhanced "management assurance" to Audit Committee and Board	
• Enhanced management update reports to the Audit Committee and Board on major risks, including deep-dive reports on topics such as risk management in procurement and tender process. To strengthen management's "assurance" to the Audit Committee and Board, self-assessment questionnaires were rolled out across all departments. Department heads were required to review and certify the effectiveness of their departmental controls, including the identification of any control issues. This backs up management's certification to the Audit Committee and Board.	Facilitation and enhancement of the work of the Audit Committee and the Board in monitoring our risk exposure.

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 2017	Description of risk change
Impact of macroeconomic developments on:		
1. Office	↑	The office rental market on Hong Kong Island core area benefited from limited new supply and demand from Chinese institutions. However, due to global economic headwinds, there was a drop in the overall demand for office space across the market from multinational companies. Further, new supply from Hong Kong Island East and lower rent in the non-core business areas has driven cost-conscious tenants to move out of core areas. The rise of co-work concept is also a disruptor to traditional office leasing business.
2. Retail	↑	The retail market was challenging during 2017 as Hong Kong retail sales continue to record a decline during first half 2017, owing to a fall in tourist numbers as well as the downturn in local sentiment. However, the decline trend reversed in later 2017 with some growth in retail sales and tourist numbers. Although early sign of recovery is seen, retail tenants are still cautious in expanding their retail enterprises, shop numbers or footprints. Pressure on rental may continue for a while until a solid growth in retail sales and higher confidence is seen.
3. Residential	↑	Reduced demand from expatriates and tighter rent budget, higher market vacancy rates and keen competition continued to exert pressure on the luxury residential leasing market leading to higher vacancies at our property. > For more analysis and mitigating measures of the above risks, see "The Marketplace" & "Review of Operations"
4. Projects	←→	Lee Garden Three obtained its occupation permit in December 2017 with the first batch of tenants already moved-in. Other tenants are also preparing their premises for occupation. Together with HKR International Limited ("HKR"), the Group acquired two pieces of adjacent land in Tai Po with a view to develop into a low-rise residential development for sale. With the HKR's and Hysan's amplified expertise, we believe the project will be executed professionally and meet market demand. The project has been in good progress. > For more analysis and mitigating measures of the above risks, see "Review of Operations"
5. Human Resources	↑	The service industry in Hong Kong continues to experience widespread labour shortages and structural changes in workforce. We are facing increased competition for skilled personnel, especially experienced front-line staff, to provide good services and support the Group's growth strategy. > For more analysis and mitigating measures of the above risks, see "Corporate Responsibility Report 2017" separately available on Hysan's website: www.hysan.com.hk

Notes:

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

←→ where "inherent risks" remained broadly the same