MANAGEMENT DISCUSSION AND ANALYSIS

A study conducted in 2016 revealed that about 9,700 building blocks in Hong Kong were more than 50 years old, with about 3,500 building blocks being in either deteriorating or poor condition. By 2046, the number of building blocks over 50 years old will approach 28,000, with the possibility of a parallel increase in dilapidation. Many of these ageing buildings have already used up all or the bulk of their development potential with little or no room for plot-ratio gains, hence they are not attractive to private developers for redevelopment. To cap it all, redevelopment projects will confront not only development risks but also potential resistance from occupiers and concern groups which can lengthen the project programme.

Current Position

Up to 30 June 2018, the URA had commenced and implemented 61 projects, comprising 58 redevelopment projects, two preservation projects and one revitalisation project since its establishment in 2001. Additionally, six redevelopment projects were undertaken in association with the Hong Kong Housing Society (HKHS). Of these 67 projects, 23 have been completed and the remainder are under planning, acquisition or construction.

The URA has also taken over to continue the implementation of ten projects that were being implemented by the former Land Development Corporation before the establishment of the URA.

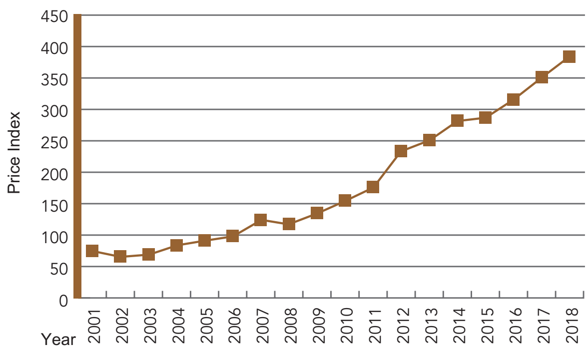
Challenges of urban renewal: Difficult to race against time and catch up the pace of urban decay

Challenges and Opportunities

To mitigate the risk posed to the value of the URA's properties under development in the event of a property market downturn, the URA has endeavoured to clear and tender two and four projects respectively that have been backlogged over the years.

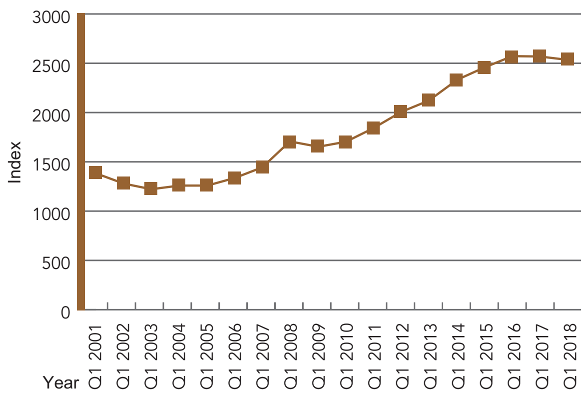
These tenders have helped to reduce the market exposure of properties under development. Such actions are appropriate at a time when the property market is at an all-time high (see Figure 1) and yet housing supply is rising with some 96,000 units becoming available in the next three to four years. This rising new housing supply, together with an upturn in interest rates, could negatively affect market sentiment. The risks are further compounded as the URA is obliged to bear high development costs by acquiring properties in its projects under the "7-year rule" and together with ex-gratia payments, which are markedly higher compared to those incurred by private-sector developers. This has led to a disparity over the past several years between the accommodation value (AV) of our projects at acquisition and at project tender. Our analysis shows that the average AV at acquisition is about $8,700 per square foot, much higher than the average AV of $7,300 per square foot at project tender. Construction costs meanwhile, though largely steady in the last two years, remain high (see Figure 2).

Figure 1: Private Domestic Price Index May 2001 - April 2018 - All Classes*



**HKSAR Government, Rating & Valuation Department, Hong Kong Property Review Monthly Supplement, July 2018*

Figure 2: Quarterly Construction Tender Price Index 2001 - 2018*



**Rider Levett Bucknall, Quarterly Construction Cost Update, June 2018*

Meanwhile, the URA has kept in view the effectiveness of the Demand-led (Pilot Scheme), which began after the Urban Renewal Strategy was issued in 2011 and is designed to harness the collective willingness of owners to help initiate urban renewal themselves. The scheme was first reviewed in 2014 with a view to enhancing the planning gains of projects. However, the refinements were still not conducive to the scheme's objectives, necessitating a more holistic review. The scheme is now being reviewed under the strategic Yau Mong District Study (YMDS) described below.

District-based Approach

By commencing a grouping of six projects in To Kwa Wan, the URA has taken steps to optimise the potential of larger clusters of dilapidated buildings in need of redevelopment. This can achieve more meaningful urban renewal benefits by creating a more community-friendly environment with a refined urban grid and appropriate land uses. The Operating Review of this report introduces the district-based approach and provides details of these To Kwa Wan projects and their related planning and social gains. The chapter on Corporate Sustainability explains the people-oriented "Project Engagement" Programme directed at the affected residents.

The URA commenced the YMDS in 2017. Previous urban renewal studies have sought to identify isolated redevelopment and other opportunities under the 4Rs. The essence of the YMDS, however, is a complete paradigm to achieve a more holistic district-based urban renewal approach by exploring new Institutional and Implementation strategies that integrate the 5Rs, including retrofitting, with a time dimension. It will dissect the often-elusive opportunities to optimise development potential, such as through the transfer of plot ratio, and it will not shirk the formidable task of examining the constraints of the prevailing legislative and institutional framework. The YMDS will make an attempt to formulate implementable and financially-sustainable projects as part of a wider set of district-based renewal strategies under the 5R initiatives that can be readily applied elsewhere in Hong Kong's older districts.

Rehabilitation

Rehabilitation is one of the two core businesses of the URA, the other being redevelopment. The URA is now the primary agent in Hong Kong for building rehabilitation, after taking over the HKHS's responsibilities under the Integrated Building Maintenance Assistance Scheme (IBMAS) in July 2015. Owners are responsible for the maintenance and repair of their buildings. However, the frequent lack of financial means, technical support, organisation power and awareness by owners are persistent hurdles to rehabilitation. To confront these obstacles, the URA has continued its rehabilitation efforts through various loan and subsidy schemes, including: the Mandatory Building Inspection Subsidy Scheme, IBMAS, Operation Building Bright (OBB), and Smart Tender. The financial assistance, technical advice, and coordination services provided by the URA to Owners' Corporations (OCs) under the schemes have been well received, judging by the enthusiastic response and frequent commendations.

Facilitating Rehabilitation through 'Smart Tender'

Launched in 2016 in response to the Chief Executive's Policy Address of that same year, the 'Smart Tender' Building Rehabilitation Facilitating Services seeks to help building owners reduce the risk of tender rigging at the works procurement stage. With over 600 applications received up until 30 June 2018, Smart Tender is already proving its popularity in providing technical services to the OCs of private buildings.

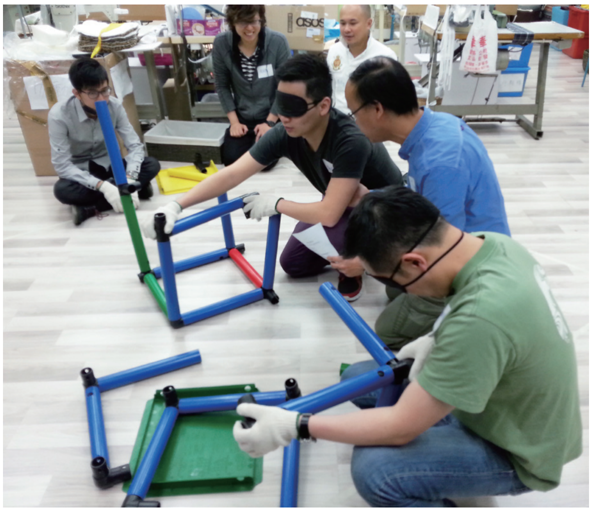
Study on New Building Rehabilitation Strategy

The study on the New Building Rehabilitation Strategy aims to identify a holistic approach to rehabilitation while seeking to reduce the number of buildings in varied and poor condition that may require redevelopment in future. Raising rehabilitation awareness for young buildings under 30 years old has been proposed as a new strategic direction to prolong the service life of buildings and create a new mindset for preventive maintenance amongst owners. For information, owners and other stakeholders can turn to the newly formed Building Rehabilitation Platform as an all-in-one information centre. Provided in the platform are, among others, information on cost references as well as the standards for rehabilitation and retrofitting, that cover the five essential elements of building structure, external façade, fire services, energy efficiency and barrier free facilities.

Preservation and Revitalisation

Section 5 of the URS spells out the URA's mandate in 'preserving buildings, sites and structures of historical, cultural or architectural value.' The URA has implemented ten projects that contain buildings for preservation or revitalisation. Three of these projects are dedicated preservation or revitalisation projects; whereas in the seven other projects, the preserved buildings form part of a larger redevelopment project site. Two preservation projects are being actively implemented. All acquired units in the Prince Edward Road West preservation project have been leased out for various uses, including social enterprise, after the renovation. For the Shanghai Street/Argyle Street preservation project, construction of new building blocks to be integrated with the preserved shophouse cluster is in progress.

The Central Market revitalisation, which commenced in 2009 as tasked by the Government under the "Conserving Central" initiative in the 2009/10 Policy Address, is another initiative involving a historic building. A simplified version of the revitalisation scheme has been approved by the Board for earlier completion of the project for public enjoyment. An ad-hoc committee set up by the Board is overseeing the revitalisation of the project, with site works having commenced in October 2017.



Team building training helps to build an effective and engaging team.

Human Resources

With an operating environment that is continuously changing, the URA needs new core competencies and training to match. The necessary technology training programmes for staff at different levels have been launched based on a Training and Development Needs Survey conducted in December 2017 through questionnaires, interviews and focus groups. Looking ahead, training will focus on: building our staff members' capacity to apply the latest technology into our work; widening their horizons and exposure via local and overseas visits; enhancing their people and leadership skills further through workshops, talks and simulation exercises, and strengthening their agility and intrapreneurship via project studies.

At the organisational level, divisional reviews were carried out to support the urban renewal directions and to lead towards better alignment and organisational effectiveness. In addition, to promote a continuous improvement culture and build on a successful earlier pilot run, Work Improvement Teams (WIT) will be continued for divisions to develop, communicate and apply their innovative ideas in order to improve work procedures and to enhance efficiency.

Stringent review of manpower requirements continued in 2017/18 with a headcount reduction of 1.8% despite a noticeable increase in workload on all fronts. Nevertheless, to nurture the leadership pipeline supply, four management trainees were recruited during the year. At the same time, to ensure competitive remuneration is offered to attract, motivate and retain the right staff to support our mission, an enhanced salary structure at the middle management level was implemented, effective from 1 April 2018.

Outlook

Hong Kong's rapidly ageing building stock remains the key challenge. Besides, the URA's operating environment is facing the continuous flux in the financial world and the sentiment of the wider community. The URA will doubtless encounter hindrances and obstacles to be overcome in pursuing its renewal programmes in the coming years. Whilst continuing with the conventional mode of delivering the 4R initiatives, the URA will look forward to the outcomes of the two strategic studies in hand, and how the proposed changes to strategies could augment our future efforts on urban renewal.

Financial Review

(I) Review of 2017/18 Results

(a) Revenue

The revenue for the year ended 31 March 2018 was $13,868 million which comprised of upfront payments from tendered projects, share of surplus from joint development projects and proceeds from sale of flats at Kai Tak. The amount is higher than the revenue of $5,035 million in 2016/17 by $8,833 million. Three projects, namely Peel Street/Graham Street (Site C), Reclamation Street/Shantung Street and Fuk Chak Street/Li Tak Street, were tendered during the year. The total site area was 4,755 m^2 as compared with total site area of 2,202 m^2 from the three redevelopment projects tendered in 2016/17. The higher upfront payments in 2017/18 was as a result of the larger site area tendered and the rising property prices during the year.

The share of sales proceeds from joint development projects of $1,128 million in 2017/18 (2016/17: $1,249 million) were revenue from projects where the sales proceeds exceeded the thresholds stipulated in the development agreements. The projects contributed to the surplus during the year are projects with development agreements executed in prior years.

Proceeds of $157 million from sales of residential flats at Kai Tak was recognized in 2017/18 (2016/17: $1,763 million). For 2017/18, the flats were sold primarily at prevailing market price. While for 2016/17, the flats were sold under Subsidised Sale Flat Scheme at 86% of the market value assessed by the URA.

(b) Other income

Of the $451 million (2016/17: $290 million) in other income for the year, $320 million (2016/17: $244 million) was interest income from bank deposits and fixed income investment products, with an average yield of 1.60% p.a. (2016/17: 1.38% p.a.). Other income also included rental income from certain properties retained by the URA.

(c) Administrative expenses

Administrative expenses for the year 2017/18 of $423 million (2016/17: $418 million) mainly covered staff costs, accommodation costs and office expenses. Cost control measures were implemented whenever possible to minimize administrative expenses.

The staffing level was reduced from 516 at 31 March 2017 to 501 at 31 March 2018 resulting from recruitment freeze to enhance cost effectiveness and efficiency of manpower investment. Of the 501 staff, 15 (31 March 2017: 15) were employed on contracts of less than three years.

(d) Write back of provision for impairment on properties and committed projects

Based on the accounting policy detailed in Notes 2(g) and 2(m) to the financial statements, write back of provision for impairment on properties and committed projects of $526 million was made in 2017/18. It is primarily due to rising property prices during the year.

(e) Surplus for the year

For the year 2017/18, the URA recorded a net surplus of $12,038 million, reflecting an increase of $8,896 million as compared to the $3,142 million net surplus for the year 2016/17. Before the write back of provision for impairment on properties and committed projects of $526 million, the surplus in 2017/18 was $11,512 million in comparison with $2,312 million reported in 2016/17. Major contributions to the 2017/18 net surplus were (a) the surplus from tendered projects; (b) the share of surplus sales proceeds from various joint development projects; and (c) the write back of provision for impairment on properties and committed projects on various projects previously made as a result of the rising property prices during the year.

(II) Financial Position at 31 March 2018

(a) Properties under development

Properties under development as at 31 March 2018 was $25,769 million (31 March 2017: $19,087 million), representing the acquisition and development costs for projects. This sum comprised of fourteen projects under various states of implementation. The aforesaid value was off-set against the cumulative provision for impairment totalling $1,980 million (31 March 2017: $3,305 million), resulting in a net value of $23,789 million (31 March 2017: $15,782 million). The increase in the net value was mainly due to accelerated acquisition of Kowloon City projects during the year and the write back of provision for impairment. It was off-set by certain projects being tendered during the year.

(b) Cash and bank balances

As at 31 March 2018, the URA's cash and bank balances and securities holdings totaled $21,221 million (31 March 2017: $19,741 million).

The URA placed the surplus cash on short-term deposits with a number of financial institutions. The URA also invested in fixed income products of the required credit rating in accordance with the investment guidelines as approved by the Financial Secretary with capital conservation as the priority.

The liquidity position, off-set by the borrowings of $2,791 million (31 March 2017: $3,288 million) mentioned in paragraph II (c) below, resulted in the net liquidity position including the securities holdings at 31 March 2018 of $18,430 million (31 March 2017: $16,453 million).

(c) Debt securities issued

The URA is rated AA+ by Standard & Poor's. As at 31 March 2018 the outstanding debt securities issued by the URA was $2,791 million under the US$1,000 million Medium Term Note (MTN) Programme.

(d) Net asset value

The URA's net asset value as at 31 March 2018 was $44,644 million (31 March 2017: $32,606 million), representing the Government's capital injection of $10,000 million (31 March 2017: $10,000 million) and an accumulated surplus of $34,644 million (31 March 2017: $22,606 million).

The financial highlights of the past ten years are summarized on page 91 of this Annual Report.

(III) Capital Injection and Tax Exemption

Following approval by the Finance Committee of the Legislative Council on 21 June 2002, the Government injected $10,000 million of equity capital into the URA in five tranches of $2,000 million each over a five-year period from 2002/03 to 2006/07. The Government continues to exempt the URA from taxation.

(IV) Waiver of Land Premia by the Government

The Government waives the land premia for redevelopment sites granted to the URA. For 2017/18, the land premia waived by the Government on 4 land grants amounted to $4,077 million. Since May 2001, a total of 40 land grants have been waived in respect of all the tendered projects with aggregate land premia totalling $19,488 million.

Without this waiver, the URA's net surplus for 2017/18 of $12,038 million for the year would have been lowered by $4,077 million to $7,961 million; its accumulated surplus as at 31 March 2018 would have been lowered by $19,488 million to $15,156 million; and its net asset value as at 31 March 2018 would have been decreased to $25,156 million.

(V) Financial Resources, Liquidity and Commitments

As at 31 March 2018, the URA's net liquidity position, including the securities holdings, totaled $18,430 million. At the same date, the URA's estimated outstanding commitments to the commenced projects, together with the construction cost on projects based on the valuation carried out by the URA's in-house professionals, stood at $17,088 million.

In addition to the US$1,000 million MTN Programme mentioned in paragraph II (c) above, the URA maintained $700 million in uncommitted bank facilities as at 31 March 2018. Securing the external funding and the credit facilities ensured the URA would have sufficient financial resources to carry out its urban renewal programme as planned.

When implementing its urban renewal programme, the URA is necessarily exposed to financial risks arising from property market fluctuations. Individual projects, with various development potentials, are tendered out at different times during property market cycles after the site clearance. Subject to the market conditions prevailing at the time of tender submission, the upfront payments may be higher or lower than the URA's acquisition costs. As at 31 March 2018, the total costs of properties under development, excluding provision for impairment was $25,769 million.

The URA estimates a total cash outlay of about $30,000 million, excluding operational overheads, will be required in the next five years to meet the costs of both its currently outstanding commitments and its forthcoming cash outlay for the implementation of the projects. This amount covers the URA's work in redevelopment, rehabilitation, preservation and revitalisation. It should be noted that the expenditure may vary subject to the level of interest shown in the various initiatives, including the expanded programme of building rehabilitation and other additional initiatives.

The URA continues to review its operating programme with the aim to maintain a highly prudent financial position with due regard for commercial principles in its operations so that the urban renewal programme may be sustainable in the long term.