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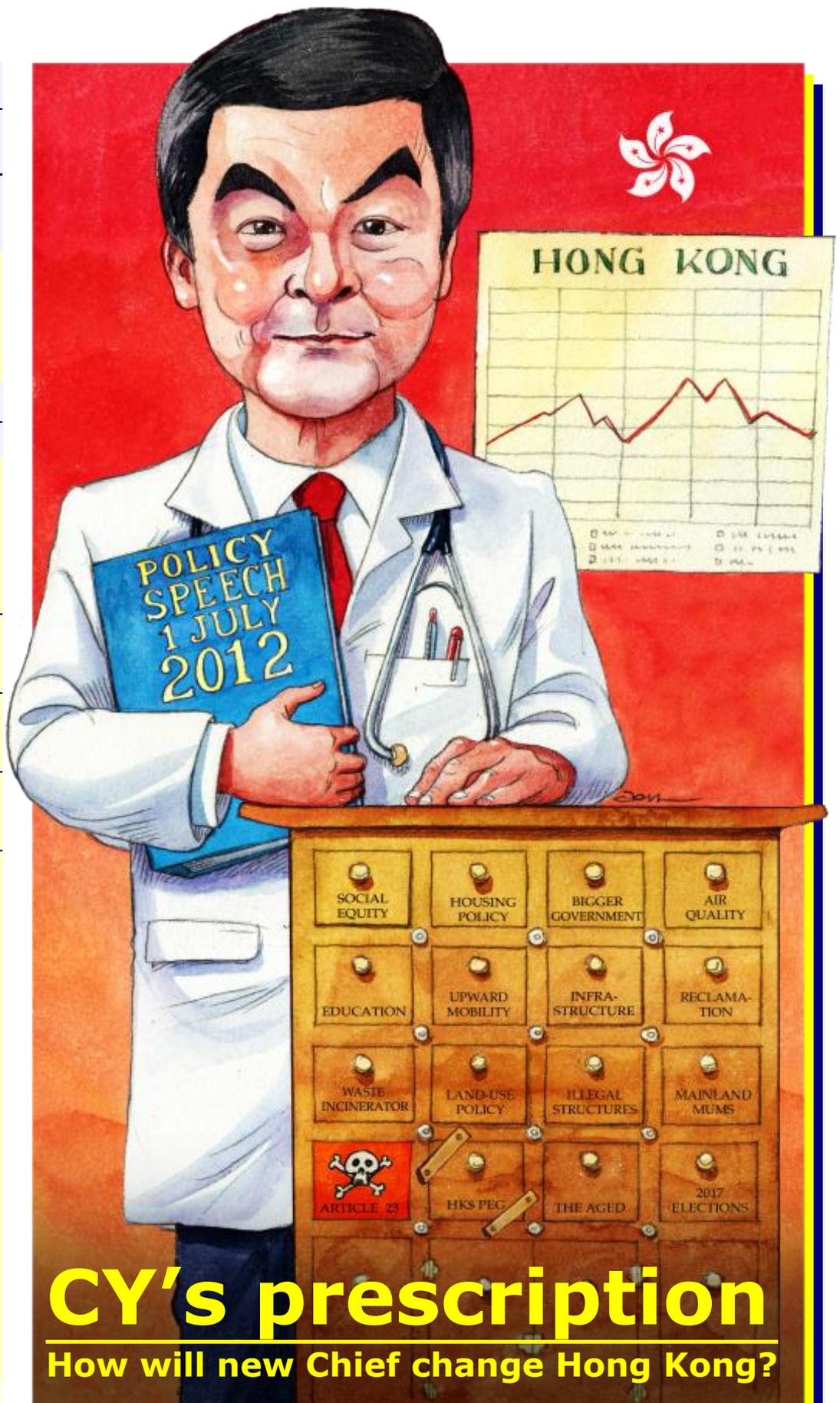
Hong Kong Strategy

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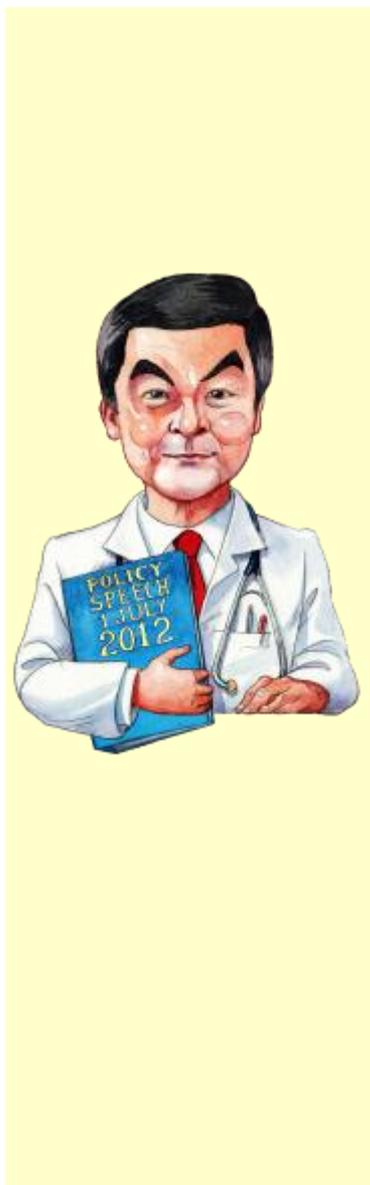
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CY's prescription

How will new Chief change Hong Kong?



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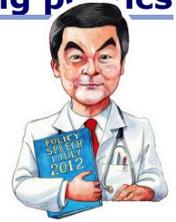
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Christine Loh



Dr Christine Loh, JP, OBE, is the cofounder and CEO of the independent, nonprofit public policy think tank, Civic Exchange. Loh is a lawyer by training, a former commodities trader, and ex-legislator before founding Civic Exchange in 2000. She has a long track record working on and writing about environmental, energy, climate change issues, and is a published author on other subjects. Having held senior positions in international business, with a decade-long career in front-line politics, and having been involved in non-government organisations from a young age, Loh is able to weave her multifaceted experience into her policy work to great effect. She is a board member of the Hong Kong Mercantile Exchange, First Pacific Company, and Thomson Reuters Founders Share Company.



Foreword

The surprise outcome of Hong Kong's recent chief executive election, in which populist candidate CY Leung defeated Henry Tang, the preferred pick of local tycoons and Beijing, has left investors with unanswered, far-reaching questions. The most pressing of these is whether pro-business Hong Kong is at an inflection point that requires a rethink of longstanding investment preferences.

To answer this and other questions, we have teamed up with Christine Loh, CEO of Hong Kong think-tank Civic Exchange (which she co-founded in 2000). Christine has previously authored several reports for CLSA, including the CLSA U Blue Books *Green ships & ports* and *Falling up!* In January 2007 *Hong Kong Business* named Christine 'Woman of the Year for 2006'. She has worked in many areas, including law, business, media and the nonprofit sector, and has served as a member of Legco, but she is best known as a leading voice on public policy in Hong Kong, particularly in promoting democracy and environmental protection. In recent years she has also been strongly associated with the campaign to save Hong Kong's harbour from excessive reclamation and overdevelopment.

Christine kicks off this report by looking into the process of Leung's election. It is essential for investors to understand this, as the electorate's composition illuminates the close ties between the political elite and the political system and the commercial sector, as well as Beijing's influence. Vested interests particularly want to know whether Leung will maintain the status quo, which in the past was essentially the chief executive's main role. In Christine's view, a schism has developed that potentially puts Hong Kong in the worst of all worlds. Change is required, and Leung could facilitate this.

To examine the intricacies of Leung's main policies, Christine divides his manifesto into five parts: population and local resources; land supply and housing; economic policy; improving livelihoods; and better governance. Finally, she explores the public's opinions of Leung and assesses how he is likely to get on with the legislature.

We also include inserts from several of our sector specialists. Property analyst Nicole Wong has moved away from residential developers in favour of commercial landlord firms, which are likely to be less impacted by policy. Regional head of power research Rajesh Panjwani has become more negative on HK utilities, given the increased possibility that expected tariff hikes may be shelved. Charles Yonts sees environmental issues as an important part of CY Leung's platform, but says there are few clues for equity investors. Meanwhile, Jon Galligan sees the duopoly among Hong Kong's supermarket giants continuing.

This is a timely and fascinating read for all Hong Kong investors.

Danie Schutte

Head of China and Hong Kong Research

CLSA views

Property: Stay away from residential players

Nicole Wong sees CY Leung taking office as marking the end of an unusual period for the property market: a bear-market land-supply mechanism in a bull market. With developers' total returns managing just 6-8% pa over 2000-10 in an era of phenomenal property-price growth, we see little reason to hold property stocks in the coming five years, when the new chief executive is pro-supply and proactive. Nicole is Underweight Hong Kong developers and sees better prospects in landlord names such as **Hang Lung**, **Wharf** and **HKLand**.



Energy: The politics of power

Rajesh Panjwani says Hong Kong's utilities also face policy risks. The key trigger is an imminent tariff hike in Kowloon and the New Territories: **CLP** plans to raise rates 40% from 2011 to 2015 to pass on higher fuel costs. Given its 2011 experience, when it proposed a 9.3% hike but settled for 4.9%, we think the proposed increase is unlikely to go through. This could impact its near-term cashflow and - longer term - its rate of return. CLP is more exposed to this than **Power Assets**, which already has much higher tariffs. Longer term, both firms face the risk of lower returns: the 2008 Scheme of Control lower rates to 10% but even this is high compared with the UK, where Power Assets recently invested in a business giving it 7.1% nominal returns. Rajesh Panjwani is Underweight Hong Kong's utilities, with Underperform ratings on CLP and Power Assets and a SELL recommendation on **CKI**.



Sustainables: Few clues

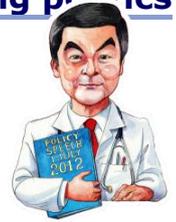
Charles Yonts says environmental issues are a major part of one of CY Leung's five manifesto planks, yet his statements to date give little direction for equity investors. Charles looks at emissions targets for electricity generation, municipal solid waste and fresh-water sourcing. Air pollution is a major issue in Hong Kong and a reason for it slipping out of the world's top 10 most liveable cities for expats. Electricity is Hong Kong's biggest source of pollution (88% of its SO₂) and the government's 2020 targets will mean a shift from coal to gas, wind and nuclear. CY Leung will face a pressing decision on building a large 3k-tonne waste incinerator off Lantau. Charles sees this as almost inevitable and notes that newer designs have addressed many of the environmental concerns. Charles highlights his BUY rating on **China Everbright International**: although Hong Kong is likely to use an established European brand for its incinerator, the firm has achieved great success across China. Hong Kong sources 70% of its fresh water from China under an agreement due to be renewed in 2014. Charles sees little chance of Hong Kong's water being cut off, but flags the risk of its water tariffs rising.



Retail: Duopolis

Jonathan Galligan takes a closer look at the two biggest players in the Hong Kong consumer market: Jardines' **Dairy Farm** and **Hutchison**. Limited land supply and high property prices have created a difficult environment for other supermarket operators to enter the market. In 2011, **Dairy Farm** (primarily through its Wellcome brand) had a 38% share of Hong Kong's supermarkets, while Hutchison Whampoa (through Park n Shop) held 35%. Jon expects their duopoly, and high property prices, to continue squeezing out competition - as it did in 2000, when deep-pocketed French chain Carrefour folded its Hong Kong operations after opening just four stores in four years.





CY's prescription

CY Leung believes Hong Kong is falling behind because it has been slow to adopt and implement forward-looking policies. He wants to speed things up by dovetailing policies effectively. Success depends on the quality of his governing team, which has yet to be announced.

A bruising election split the pro-establishment camp, but opened up a debate on what needs to change. The losing team represented the economic status quo. Leung's victory has moved the debate away from the need for greater social justice to how it can be achieved.

Land policy lies at the heart of the challenge. Leung has already promised to supply more land through sales, reclamation, regeneration and opening up developable areas in the New Territories. He wants to build more public rental housing for low-income families and subsidised flats for sale to median-income households. The question is how far and fast he can move.

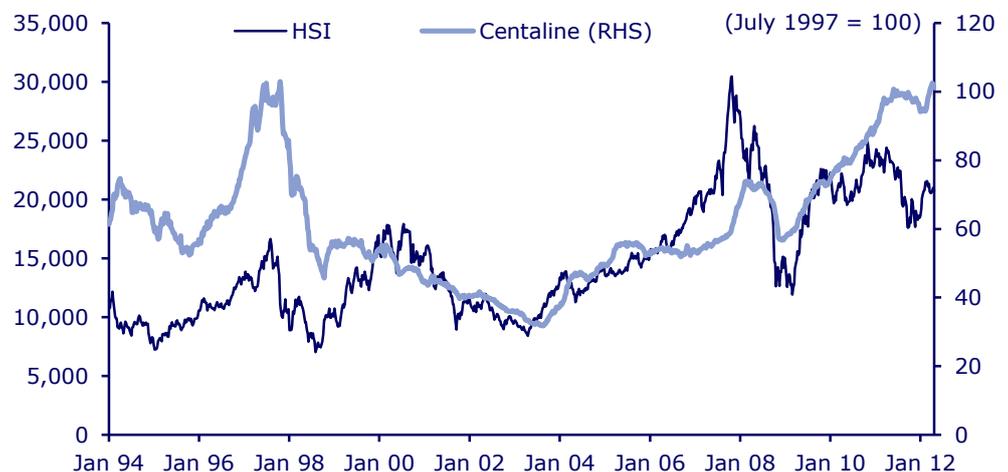
Leung could also change the administrative practice of spending land-related income on physical infrastructure and divert it to recurrent needs instead. Concurrently, he could lift the artificial cap previous administrations put on recurrent expenditure, which would free more funds to improve education, health, welfare, the environment and Hong Kong's general liveability.

With US\$262bn of fiscal reserves, Leung does not need to raise taxes for his programmes. This massive war chest also makes direct tax increases politically unviable.

Despite their suspicions about the new chief executive, people nevertheless expect competence. Leung could open the door to an acceptance that pro-Beijing individuals can capably lead Hong Kong, easing the longstanding "us and them" conflict. It helps that Beijing does not seem to be pushing Leung to pass Article 23 of the Basic Law (widely seen as a threat to freedom) anytime soon; but this will be a tough test when Leung makes a move.

Finally, Leung has to put in place acceptable election methods for Legco in 2016 and the chief executive in 2017, as these are next steps in Hong Kong's electoral journey.

Hang Seng and Centaline property price indexes



Source: CLSA Asia-Pacific Markets

CY Leung is impatient for change

The question is no longer what should change but how to do it

Land and housing are priorities

Use land incomes for wider social needs and ease cap on recurrent spending for social improvement

Can't raise taxes with a large war chest

People expect competence

Democracy and freedom remain on HK's agenda

Who is CY Leung?



Early years

Born in Hong Kong in 1954, Leung Chun-ying (梁振英) attended Hollywood Road Police Primary School, as his father was a policeman. He went to King's College on a Police Force scholarship for secondary school and then gained a higher diploma in building surveying at the Hong Kong Polytechnic before going to study valuation and estate management at Bristol Polytechnic in England between 1974 and 1977.

Commercial career

In 1977, Leung joined the Hong Kong office of Jones Lang Wootton, a large British real-estate consultancy. He became an equity partner after five years. In 1988, he was appointed as one of the four members of the firm's Asia Pacific management committee. He eventually founded CY Leung & Co Ltd in 1993, and in 1999, he and other shareholders swapped part of their shareholding in CY Leung & Co for shares in DTZ Holdings plc to create DTZ Debenham Tie Leung Ltd. In 2006, through another share exchange, Leung became the largest single personal shareholder of the London-listed DTZ Holdings plc and took on the responsibilities

of chairman of Asia Pacific. DTZ Holdings plc was sold in December 2011 and has since been delisted.

Doing business in China

CY Leung started giving lectures and seminar on land, surveying and commercial issues to Chinese officials in Shenzhen soon after 1978, when China embarked on market reforms. He helped to work on land sales issues with various Chinese authorities. In 1993, he as the first non-mainland professional to open a real-estate service company in mainland China. The normal requirement of a joint venture with a local firm was waived in his case, which according to Leung set a precedent for other non-mainland firms in the industry.

A potential political star

Leung's commercial connections in China also blossomed into many political appointments during the negotiation and transition years from British to Chinese rule. He had already been spotted as a potential star in the early 1980s when British and China started to discuss the transfer of sovereignty.

The most important business elites were appointed to the Basic Law Drafting Committee to design the post-1997 constitution. Leung was appointed to a sister body, the Basic Law Consultative Committee (BLCC), set up by Beijing in Hong Kong to consult the people on drafts of the Basic Law, and was its secretary general.

Trusted by Beijing

In the light of 4 June 1989, Sino-British relations soured. Leung was seen as trusted by Beijing, and he often articulated Beijing's view and perspective of the transition. He was appointed as the Group Leader of the Political Group of the Preliminary Working Committee of the Preparatory Committee of the National People's Congress - a body

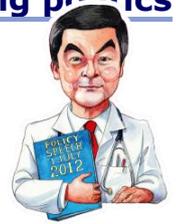
set up to prepare for the final stages of the handover - and then appointed as a vice-chairman of the Preparatory Committee. As a result of Sino-British disagreement over electoral arrangements in 1995, the Hong Kong Legislative Council was disbanded on 30 June 1997 and an appointed Provisional Legislative Council was set up to take over instead. Leung was appointed to that body and at the same time appointed as an Executive Council member of the first post-1997 administration under the leadership of the first chief executive, Tung Chee Hwa. He became the convener of the Executive Council in 1999 - a post he held until he resigned in 2011 after declaring his candidacy for the chief executive election.

'He does not below to anyone'

Ronnie Chan, chairman of Hang Lung Properties, has described CY Leung as someone who 'does not engage in small talk; he is always serious' and 'he does not belong to anyone, he joins no cliques, he cannot be bought . . . No business groups can own him; he does not promise anyone anything lightly; he does not make deals'.¹

CY Leung is married with three children.





Hong Kong's hopes and fears of the CY Leung era

A unique elitist election system to buttress the status quo

CY must be hoping to serve two terms

Beijing's broad criteria: "patriotism" . . .

. . . "experience", competence . . .

. . . and popularity - this election's Trojan horse

The road to Chiefdom

After a campaign full of surprising twists and turns, Leung Chun-ying - CY Leung - emerged victorious to be Hong Kong's next chief executive on 25 March 2012. His election has brought both fear and hope to Hong Kong: fear because people associate him with China's illiberal political forces that may constrain their way of life; and hope because he may push for greater social equity in a city where the gap between rich and poor has become the widest among developed economies.

This report looks at the extent to which CY Leung may stand for "change", what kind of change he may work towards and his ability to deliver on campaign promises.

Before discussing how Leung may change Hong Kong, it is important to examine the city's unique chief executive election system, as it is also a good proxy to understand its political economy.

As it stands, it reflects who makes up Hong Kong's political elite, and how closely they and the political system are tied to commercial interests. The system was designed to maintain the status quo. The election that Leung won also shows the hand of Beijing in shaping Hong Kong politics. These are all aspects of local life and represent deep-rooted conflicts that are not so easy to change without major surgery.

CY Leung has got to be hoping to serve two terms of five years each (2012-17 and 2017-22), the maximum allowed under the Basic Law, Hong Kong's post-1997 constitution. Leung's contribution to change during his first term will determine his re-election prospects in 2017.

Beijing's criteria for chief executive

Beijing's criteria for an acceptable chief executive are that he should be patriotic, capable and popular. Both Henry Tang and CY Leung are "patriotic" because they are loyal to Beijing on key issues, mostly relating to the pace, direction and form of constitutional reform. Nevertheless, there are many other policy areas where Hong Kong has autonomy and where the chief executive - essentially a glorified mayor - can make a real difference to the quality of life for the people of Hong Kong.

Henry Tang's supporters argued that he should be considered more "capable" in terms of hands-on experience, because he has held executive positions in the government as minister of commerce, financial secretary and chief secretary. Leung had been a member of the Executive Council, which is an advisory, non-executive position. One of Tang's key attack points during the campaign was Leung's lack of administrative experience.

In turn, Leung argued that administrative experience was not necessary for political leadership. A political leader's success depends on 'clear vision, integrity, competence and ability to garner public support'.²

As for popularity, this criterion was the Trojan horse in this election. Leung took it literally. He reached out to Hong Kong people and his campaign worked to gain public acceptance like candidates do in real universal-suffrage elections elsewhere in the world (see Section 4).

The 1,200 member Election Committee nominates and elects the chief executive

Campaign is relatively short

Complex election of sectors and subsectors

Subsector seats are for vested interests

Political ex-officio voters

Religion is there too

How does Hong Kong elect its chief executive?³

Hong Kong has a highly unusual system for electing its head of government. For the 2012 election, an Election Committee comprising just 1,200 members elected the chief executive. The Election Committee members first had to be selected. They then nominated candidates to stand in the election and finally elected the chief executive. The timeline for all this was relatively short.

Figure 1

Hong Kong's chief executive campaign timeline

CY Leung announced candidacy	27 Nov 2011
Nominations for subsector elections	8-15 Nov 2011 (all subsectors except District Councils) 18-24 Nov 2011 (District Council subsectors)
Subsector elections	11 Dec 2011
Election Committee commencement	1 Feb 2012
Nomination of CE candidates	14-29 Feb 2012
Election	25 Mar 2012

Source: Civic Exchange and Electoral Affairs Commission, Hong Kong

It must be emphasised that this system is evolving. Beijing's promise to Hong Kong is that in 2017, the people will directly elect the chief executive. The debate is over how to design and form a new nomination committee.

Election Committee composition

The 2012 Election Committee was divided into four major "sectors":

- ❑ First sector - 300 seats for commercial, industrial and employers' corporations and associations.
- ❑ Second sector - 300 seats for professionals, such as doctors, lawyers, accountants, nurses, teachers, etc.
- ❑ Third sector - 240 seats for social organisations such as trade unions.
- ❑ Fourth sector - 204 seats for political bodies in Hong Kong and the mainland.

These sectors were then subdivided into individual "subsectors" - effectively interest groups - with each subsector allocated a number of seats. The members of these subsectors are professional individuals, commercial corporate bodies, or special bodies, and were selected by the voters in their subsector. These subsectors also included three groups of politicians: 55 seats for Beijing-appointed Hong Kong deputies to the Chinese People Political Consultative Conference (CPPCC); 121 seats for Hong Kong's District Councils (which in total have 412 elected and 68 appointed councillors); and 28 seats for the Heung Yee Kuk (a traditional rural association of village elders).

In addition there were two ex-officio subsectors: one comprised the 60 members of the Hong Kong Legislative Council (Legco); and the other the 36 Hong Kong deputies appointed by Beijing to China's National People's Congress.

Finally, there were 60 seats nominated by six designated religious bodies representing Buddhists, Catholics, other Christians, Confucians, Muslims and Taoists.⁴

Figure 2 shows the breakdown of Election Committee members by sector and subsector.

Figure 2

Election Committee 2011: No. of voters and seats by sector and subsector		
Sectors and subsectors	No. of voters	No. of seats
First sector		
1. Catering	7,934	17
2. Commercial first	860	18
3. Commercial second	1,783	18
4. Employers' Federation of Hong Kong	122	16
5. Finance	125	18
6. Financial services	568	18
7. HK Chinese Enterprises Association	321	16
8. Hotel	101	17
9. Import and export	1,434	18
10. Industrial first	610	18
11. Industrial second	695	18
12. Insurance	135	18
13. Real estate and construction	754	18
14. Textiles and garment	3,188	18
15. Tourism	1,118	18
16. Transport	201	18
17. Wholesale and retail	6,879	18
	26,828	300
Second sector		
18. Accountancy	24,630	30
19. Architectural, surveying & planning	6,778	30
20. Chinese medicine	5,864	30
21. Education (teachers)	86,618	30
22. Engineering	9,052	30
23. Health services (nurses)	39,128	30
24. Higher education (universities)	9,106	30
25. Information technology	5,522	30
26. Legal	6,583	30
27. Medical	11,118	30
	204,399	300
Third sector		
28. Agriculture and fisheries	159	60
29. Labour (unions)	626	60
30. Social welfare	14,429	60
31. Sports, performing arts, culture & publication	2,358	60
	17,572	240
Fourth sector		
32. CPPCC	141	55
33. Heung Yee Kuk	147	28
34. Hong Kong & Kowloon district councils	200	59
35. New Territories district councils	212	62
	700	204
Total subsector voters	249,499	
Ex officio		
A. HK Legislative Council	60	60
B. National People's Congress	36	36
Religion		
C. Religion	Nominated	60
Total Election Committee members		1,200

Source: Electoral Affairs Commission

For the 2012 chief executive election, there were in fact only 1,193 voters as a few individuals have double votes but can only cast one vote.

Subsectors and functional constituencies

Subsectors are more numerous than functional constituencies, which have been used to elect Hong Kong legislators since the mid-1980s, but they are vested-interest derivatives of functional constituencies. In the current legislature, half of the 60 legislators were elected by functional constituencies. Thus, vested interests are embedded not only into the system that elected the chief executive but also half of the legislature. In other words, vested interests are deeply entrenched into Hong Kong politics.

Don't forget functional constituencies as well

**Of the subsector voters,
some are humans . . .**

**. . . while some are
corporate bodies**

**Closer look at
Real Estate and
Construction subsector**

**Many seats in commercial
subsectors already
spoken for**

CY's challenge in reforming the constitutional system in Hong Kong will require him to deal with both functional constituencies for the 2016 Legco election (laying the groundwork for the major change to the legislative election in 2020 that Beijing promised may also be elected by universal suffrage) and the subsector elections for the 2017 chief executive election.

Individuals versus corporate subsectors

The professionals subsector members are straightforward enough - if you are registered to practise in Hong Kong as a doctor, you can register to vote in the medical subsector. Likewise, if you are a registered solicitor or barrister in Hong Kong, you can register to vote in the legal subsector. If you wish to stand for selection, you need five nominations from a subsector's registered voters. In the 2011 subsector selection, 83 doctors and 66 lawyers stood for selection for 30 seats each in their respective subsectors.⁵

Less straightforward are the corporate bodies. The real estate and construction subsector provides a good example. Companies that are members of the Real Estate Developers Association, Hong Kong Construction Association and Hong Kong E&M Contractors' Association make up the subsector. A member company can nominate a person to be its "authorised representative" to stand for selection. This person needs five nominations from member companies in the subsector.

Real estate and construction subsector

In the 2011 subsector selection, the real estate and construction subsector had 18 candidates standing for selection to its 18 seats. In other words, it was an uncontested selection. Election records show Li Ka-shing of Cheung Kong, Lee Shau Kee of Henderson Land, KS Lo of Great Eagle, Thomas Kwok of SHKP, Daisy Ho of Shun Tak, Ronnie Chan of Hang Lung, and Robert Ng of Sinoland all stood for selection in this subsector.

Other property developers, such as Raymond Kwok stood in the Commercial First subsector, which is for the corporate members of the Hong Kong General Chamber of Commerce; and Victor Li of Cheung Kong, Peter Woo of Wharf, Gordon Woo of Hopewell, Henry Cheng of New World and Vincent Lo of Shui On were selected for the CPPCC subsector.

Phenomenon of uncontested seats

Many business subsectors were also uncontested, such as the Employers' Federation, finance, import and export, Chinese Enterprises Association, textile and garments, industrial and agriculture and fisheries subsectors. This means these are tightly networked subsectors that can field an agreed list. The agricultural and fisheries subsector is especially interesting - it has 60 seats, comparatively high for its economic contribution to the economy.

Chinese People's Political Consultative Conference

The CPPCC is an appointed body in the Chinese political system. Beijing has appointed some 200 Hong Kong deputies to the national CPPCC with 60% of them being top-tier business people. The CPPCC is explicitly stated as a "united front" body aimed to build support for the ruling Chinese

Communist Party. From the early 1990s, Beijing stepped up efforts to gain the support of Hong Kong's tycoons by appointing them to the CPPCC, which holds its annual meetings at the same time as China's National People's Congress, usually in March each year.

Candidates needed 150 nominations for starters

Tang enjoyed the most nominations

CY's supporters

Those who didn't nominate CY

Who nominated CY Leung?

To get to first base, a candidate standing for the 2012 chief executive election had to obtain 150 nominations from among the members of the Election Committee before the nomination period closed. An Election Committee member can only nominate one candidate.

As noted above, the total pool of electors for this election was only 1,193, out of which 883 members of the Election Committee nominated a candidate. This meant 310 members did not nominate anyone.

CY Leung got 305 nominations, Henry Tang got 390, and Albert Ho (chairman of the Democratic Party of Hong Kong) got 188.

Figure 3

Nomination distribution



Source: Electoral Affairs Commission

Leung did well with the agriculture and fisheries subsector, getting 57 nominations out of its 60 members. He has strong links with the trade unions - he secured 29 nominations from the labour subsector and 20 nominations from the pro-Beijing Federation of Trade Unions (FTU). He also got 60 nominations from the pro-Beijing political party, the Democratic Alliance for the Betterment and Progress of Hong Kong (DAB).⁶ Being a surveyor by profession, he collected 25 nominations from the surveyor, engineering, planning and architecture subsectors. He also had 12 nominations from the finance and financial services subsectors. His supporters among the property developers were the smaller players, such as Ronnie Chan of Hang Lung and Vincent Lo of Shui On. Among the first-tier players, he had Walter Kwok, the former chairman of SHKP, who has family disputes with his brothers and no longer has a day-to-day executive role in the company.

Rival's nominators

The other two Kwok brothers - Thomas and Raymond Kwok - supported Henry Tang, as did Cheung Kong's Li Ka-shing and his son Victor Li, Henderson Land's Lee Shau Kee and his son Peter Lee, and New World's Henry Cheng.⁷ Other major developers included Robert Ng of Sinoland, Joseph Lau and Joseph Lau of Chinese Estates and Gordon Wu of Hopewell Holdings. Presumably, they also threw nominations they controlled behind Tang.⁸ The Liberal Party helped to deliver 62 nominators among its party members and allies in the business sector.⁹ Tang also had David Li of Bank of

CY Leung was not the establishment or pro-democracy choice

Rival's self-destruction meant CY was the only man standing

Follow the money

Leung's donations kept rising even beyond election date

East Asia as his campaign chairman, who acted in the same role for Donald Tsang. Lau Wong Fat, the chairman of the Heung Yee Kuk and a member of the HKSAR Government's Executive Council also nominated Tang.¹⁰ The Heung Yee Kuk controlled 28 votes in the Election Committee. The DAB had 20 members who nominated Tang although many more nominated Leung.¹¹

What the nominations indicated

The number and character of the nominators indicated that Henry Tang was the favoured candidate among the elites of the business establishment. Those who nominated Albert Ho (mainly in the professional subsectors) wanted a candidate to speak up for the liberal democratic cause, and they would not have nominated either Tang or Leung. Indeed, those voters stood for selection to the Election Committee to give a candidate in the democratic camp a chance to get to the starting block.

Who voted for CY Leung?

Henry Tang, suffered a string of controversies that he did not recover from, the most damning of which was the discovery of a very large, illegally built basement in one of his family homes. When this was exposed by the media, Tang said the basement was his wife's idea, which further damaged his credibility. The government was duty bound to investigate, which may well lead to prosecution of Tang and/or his wife, making him unelectable. Topping it off, Tang accused Leung of what he supposedly said at confidential Executive Council meetings, losing Tang further support from among Election Committee members, and apparently also from Beijing, according to media reports (see Section 2).

Donations to Leung and Tang

The law provides that a chief executive election candidate can only spend up to HK\$13 million on his campaign. CY Leung received a total of HK\$14.84 million and spent HK\$11.2 million, while Henry Tang received HK\$11.29 million and spent slightly less than Leung. Amounts raised and unspent have been donated to charity.¹²

Now that donations to the candidates have been publicly released by the Registration and Electoral Office, it can be seen from Figure 4 that Henry Tang's donations stalled after his illegal basement became known, although both candidates had already raised the bulk of their donations by mid-February.

Figure 4

Donation trajectory



Source: Ming Pao

Beijing threw its weight behind CY

The hand of Beijing supporting CY

Clear win for CY Leung

About 50% of CY Leung’s donations came from the little-known Association of Experts for Modernisation, whose members have good relations with Beijing. Some donations were received after the election, presumably from people who wanted to make a gesture of support, albeit late. Henry Tang received donations from executive directors of Cheung Kong, as well as Hutchison Whampoa. Stanley Ho and Pansy Ho of Shun Tak also donated.¹³

Beijing’s clear support

With Henry Tang’s self-destruction, there could only be one choice left for Beijing - CY Leung. The issue then was to ensure he would get enough votes on 25 March during the first round of voting to prevent a second round. To proceed to a second round would be an indication that Beijing had lost control, an outcome to avoid at all costs.

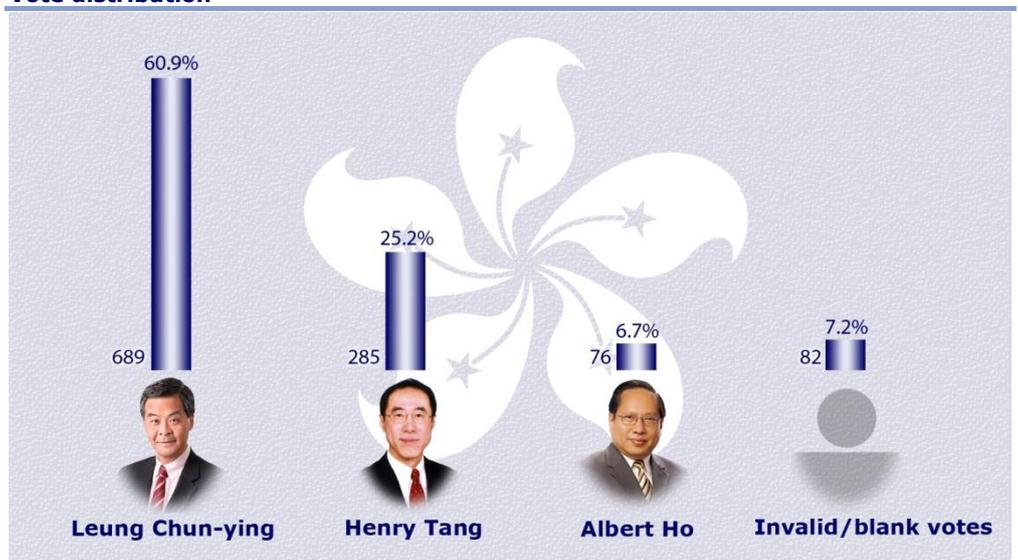
The current election law provides that if the first round fails to result in an outright winner with at least half of the votes from the Election Committee, the candidate with the lowest number of votes shall be eliminated and then a second round of voting shall take place on the same day. If no candidate gets at least half the votes, there will be a fresh election in May 2012. Beijing definitely did not wish to open up the election again, as it would just raise more controversies.

In terms of hard numbers, the law provides that a successful candidate needed to get 600 plus 1 votes in the first round even though on this occasion there were only 1,193 voters.

Leung received 689 votes. In the last days before the election, Beijing-controlled newspapers began rooted for Leung, and Beijing’s office in Hong Kong - the Central Liaison Office - reportedly called in Election Committee members, including staunch supporters of Henry Tang, to persuade them to switch their support to Leung.¹⁴ The traditional pro-Beijing political forces in Hong Kong - the DAB (147 votes) and FTU (60 votes) - declared they would give all their votes to Leung.¹⁵

Figure 5

Vote distribution



Source: Electoral Affairs Commission

... but he was not the frontrunner at the start

CY was not the establishment or pro-democracy choice

A reputation-denting experience

Leung takes office on 1 July, and makes his major policy address in early October

Figure 6

Nominations versus final vote

	Nomination 29 February	Final vote 25 March	% of total votes
CY Leung	305	689	(60.9)
Henry Tang	390	285	(25.2)
Albert Ho	188	76	(6.7)
Total valid votes		1,050	(92.8)
Invalid votes		7	(0.6)
Blank votes		75	(6.9)
Voter turnout		1,132	(94.9)
No show		68	(6.0)
Total votes		1,200	(100.0)
Total eligible voters		1,193	

Source: Electoral Affairs Commission and Civic Exchange

Who cast invalid/blank votes or didn't vote?

Who were the Election Committee members who cast invalid votes (spoilt ballots) or blank votes or abstained from voting (no show)? On 21 March, the pan-democratic camp voters met to discuss its voting strategy - they decided voters could vote for Albert Ho, cast a blank vote or abstain from voting. The pro-business Liberal Party, previously staunch supporters of Henry Tang, decided they would not vote for Leung - their members would either vote for Tang or cast blank votes.¹⁶ The pan-democrats and the Liberal Party controlled about one-fifth of the votes in the Election Committee.

CY Leung not entirely scandal free

While Henry Tang's personal credibility was shot during the campaign, Leung's reputation was dented as well. The issue had to do with his role as a judge in 2001 for the government-organised design competition for the West Kowloon arts hub. Judges had to declare any conflict of interest they had with the competing designers. Leung's firm was listed as a property adviser on one of the competing team's submission, but he did not declare the business link before voting. Leung said he did not make a declaration because he did not know that his partners had given advice.¹⁷

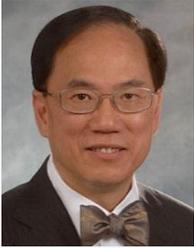
Figure 7

Timeline to new administration

9 May	CY Leung's reorganization package put to LegCo for funding
May/June	Beijing confirms ministerial appointments
Mid-June	LegCo expected to approve funding for reorganisation package
June	Announcement of other political appointees
1 July	CY Leung takes office
Mid-July	LegCo breaks
9 September	LegCo election
Early-October	First LegCo sitting and CY Leung's first policy address

Source: Civic Exchange

Criticism of Donald Tsang's policies



Donald Tsang has had major impact on Hong Kong's economy for a substantial period of time. He became secretary of the treasury in 1993, financial secretary in 1995, chief secretary in 2001 and chief executive in 2005. CY Leung complains in his manifesto that Singapore surpassed Hong Kong in overall GDP in 2010,

and by 2015, Hong Kong will fall behind Shanghai, Beijing, Guangzhou, Shenzhen, Suzhou and Tianjin in terms of the size of its economy. Moreover, in 1997 Hong Kong's economy was 2.1% of the size of the USA, but by 2010 it was only 1.5%.¹⁸

CY Leung's frustration can be seen from his earlier writing in January 2010:

Much energy has been spent - and probably wasted - in the past year on how Hong Kong is threatened by Shanghai as a financial centre. At various times in the past two decades, analysts have claimed that Hong Kong is under threat from Singapore or Shenzhen or some other Asian city. Fortune magazine may have been the bluntest in 1994 with its "Death of Hong Kong" cover story, but it has not been alone among international publications in forecasting Hong Kong's demise. Those analyses painting a rosy picture for China's economic rise have tended to claim that Hong Kong will be progressively marginalized to become "just another Chinese city". Those painting a darker future for China have argued that Hong Kong would inevitably be sucked in. Either way, Hong Kong is seen as doomed.

Needless to say, I have little time for such analyses, which tend to oversimplify and misdepict the likely future roles of Shanghai, Shenzhen or Singapore about as much as they do Hong Kong. This is not to say that Hong Kong faces no competitive challenges, or indeed to say that Hong Kong does not have to be prepared for them. On the contrary, it faces many and some of them are serious. But these challenges do not come from other cities in the region. They come from within Hong Kong itself. Solve these, and there is no centre in Asia that will usurp Hong Kong's potential as Asia's "world city". Fail to solve them, and Hong

Kong is indeed likely to become "just another Chinese city". The fate of Hong Kong's future lies in its own hands. Our challenge is to identify and focus on our core problems and tackle them, and on our competitive advantages, and to exploit fully their potential.

He then discussed the Asian currency crisis and SARS, saying that the impact of these and other events was that:

Upward mobility came to a juddering halt. After a decade in which a booming economy had brought fast rising living standards - and where the policy of localization combined with massive emigration to give promotion opportunities to huge numbers of local people - the economic environment turned horribly negative. Many lost their jobs and, lacking any unemployment safety net, had to return to the workforce at lower salaries. For those with their own homes, the collapse of house prices compromised their only store of wealth. The immigration of low-skilled workers from the mainland has also affected the low-income groups. Data on salary developments show that a million people - about 30% of Hong Kong's workforce - earned less in 2006 than they did in 1996. In the same decade, GDP per capita increased by 34%. Restaurant workers today earn 4% less than they did 17 years ago. Workers in fast food outlets earn 19% less. Those driving container lorries earn 30% less.

Through the 1990s, the widespread sense of upward mobility and improving living standards created a highly positive social environment. But today, with upward mobility largely gone, or at least not as obvious compared to the past, the grim reality of a generally poor quality of life has hit home hard among Hong Kong families. In spite of international perceptions of an opulent society (on a PPP basis, Hong Kong is among the five richest societies in the world) the reality is that half of Hong Kong's working population earn less than US\$1,300 a month, with 5% earning less than US\$410.

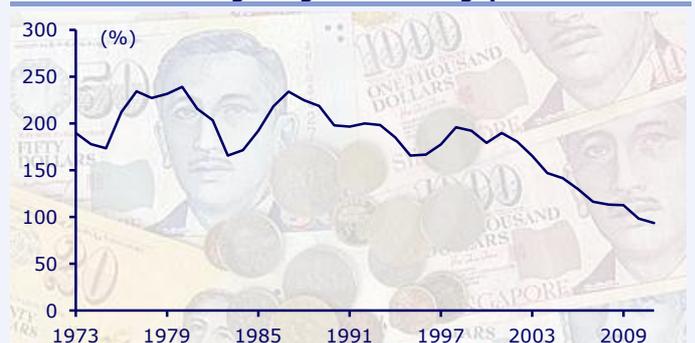
CY Leung, *Hong Kong Journal*, January 2010¹⁹

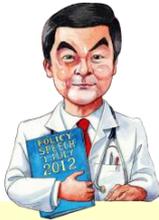
Relative GDP: Hong Kong as % of USA



Source: CEIC

Relative GDP: Hong Kong as % of Singapore





For the public, it's about liberal values and social justice

For vested interests, the status quo is best

Will he affect the cost of business?

Beijing has traditionally supported the status quo

Does CY share the people's core values?

How this changes Hong Kong

CY Leung's victory raises numerous questions for different groups of people in Hong Kong. The general public wants to know whether he will seek to constrain Hong Kong's liberal "core values", which would be seen negatively; create a more equal society by bridging the divide between rich and poor, which would be seen positively; and promote democracy, which is seen as a way to maintain Hong Kong's 'high degree of autonomy' vis-à-vis Beijing's interference and to ensure the public interest is put ahead of vested interests.

Vested interests in particular want to know to what extent CY will maintain the status quo. For example, major property developers are concerned about his land policy and its impact on property prices, the Heung Yee Kuk wants him to keep the existing small-house policy (Section 3), and construction-related interests want to be assured of many more infrastructure projects.

Beyond specific interests, there are general concerns too. In his first interview as the chief executive-elect with foreign media, Leung was quoted as saying that he would address imbalances in the economy and make companies 'pay for their costs to the community,' which raised concern among the business community about what it meant and whether new policies would increase the cost of doing business, such as raising the minimum wage, establishing pensions, raising taxes etc. His office clarified subsequently that it was 'a misquote'.²⁰

For Beijing, the chief executive is expected to maintain "stability and harmony", which has traditionally meant keeping the political-economic status quo. Beijing will have a view on how Hong Kong should move towards universal suffrage because that may upset the status quo. As explained in Section 1, the subsectors and functional constituencies reflect the current commercial and political interests. Changing the political system will affect them and the balance of influence in Hong Kong.

This section explains why Hong Kong people fear their core values may be under attack and their desire for a leader who can both preserve a liberal way of life in Hong Kong and at the same time create a fairer society where the city economic gains are more fairly shared.

Hong Kong's core values

Hong Kong's "core values" are about an open and liberal way of life that is distinct from life in mainland China. In 2004, the HKSAR Government under the first chief executive Tung Chee Hwa issued a statement that described the city's core values this way:

Our governance is built on core values such as the rule of law, freedom, equality, openness and a corruption-free society.²¹

CY Leung's campaigning policy document stated that he supports:

Upholding the core values of Hong Kong: human rights, freedom, rule of law, democracy, equality and justice.²²

Protecting "core values" remains an issue

His campaign manifesto, published in March 2012, stated that:

I firmly subscribe to integrity, the rule of law, a clean government and democracy as our core values and the foundation of our prosperity and stability. I shall do my utmost to safeguard the rights of every citizen and ensure that those rights are fully respected.²³

However, Henry Tang accused Leung of not representing Hong Kong's core values during election debates. The question of what Leung stands for continues to be raised. On 1 April 2012, the chief executive-elect office issued the following statement after a protest called on him to step down, showing the sensitivity of this issue:

Chief executive-elect CY Leung said he dearly cherishes freedom, human rights, democracy and the rule of law, Hong Kong's core values, and that is why he respects the public's right to express divergent views.²⁴

Henry Tang also accused CY Leung of suppressing freedom of speech, claiming he had proposed to shorten the licence renewal term for the vocal local station Commercial Radio at a high-level government meeting (when CY was an Executive Councillor) in 2003, and that he had advocated the use of riot police and teargas against protesters opposed to the proposed national security legislation, which the government was attempting to pass and which ultimately failed due to public pressure. Leung denied he ever said such things.²⁵

Communist Party membership

Is CY a CCP member?

CY Leung has repeatedly denied he is a member of the Chinese Communist Party (CCP). Why do people keep asking him?

During the Cold War, the British and Chinese authorities accommodated each other in colonial Hong Kong through ignoring each other. The patriotic community in Hong Kong stayed out of the way of officialdom and gravitated around China-owned companies, schools, bookstores, newspapers and neighbourhoods.

Long history of "them" and "us"

The mainstream and patriotic communities coexisted alongside each other. During the violent, Cultural Revolution-inspired riots of 1966 to 1968 perpetrated by "leftists" in Hong Kong, the patriotic community became discredited and distrusted. This "them" and "us" distinction has persisted to today.

Does it matter?

Mainstream suspicion remains as leftists have assumed positions of political leadership in the Executive Council, Legislative Council, District Councils and other bodies via appointment or selection post-1997. CY is among those high-profile people in Hong Kong known to be patriotic, and thus is constantly asked if he is a CCP member.

CY Leung is categorical in his answers. When asked after the election he said:

I am not a member of the Community Party. I am not a so-called underground member of the Communist Party. In fact, I am not a member, and have not been a member of any political party anywhere in the world.²⁶

On 28 March, the official CCP newspaper, *People's Daily*, posted on its website a biography of CY Leung and used the word 'comrade' to describe him - a description knowledgeable people say is usually used for Party members, and which was not used for previous chief executives Tung Chee Hwa and Donald

Staff-hiring controversy

Tsang. As questions were raised about CY Leung and the CCP, the item quickly disappeared from the newspaper's website. CY felt it necessary to call in photographers to witness him signing a denial statement.²⁷

In April 2012, CY Leung brought a campaign assistant, Ms Ran Chen, to work in his chief executive-elect office. He had already brought in several other short-term contract junior workers, who helped him during the campaign, to supplement manpower allocated to him by the current administration. Media reports noted Chen was from the mainland, not a Hong Kong permanent resident, and had been a member of China's Communist Youth League (CYL). Critics questioned the wisdom of bringing her on board when Leung could have selected others to help him, while others pointed out many young mainland students join the CYL. The chief executive-elect's office said the short-term workers would not automatically join the new administration.²⁸

Suspicious hard to dispel but can it open a new door?

Does it matter whether Leung is a member of the CCP or that he has associations with the Party and its institutions? It is hard to say exactly what it means to the people of Hong Kong. For them, perhaps not knowing is a problem and gives rise to continuing suspicion of false pretences and hidden agendas that cannot be laid to rest easily. Then again, CY may open the door to an acceptance that pro-Beijing individuals can lead Hong Kong politically, and thus lead to an easing the longstanding "them" and "us" conflict.

Broader perspective

To the Hong Kong public, the issue of CY Leung's connection to the mainland's political interests has other perspectives that impact directly on their livelihood.

Who CY owes for his election

First, he owes a good part of his success to the Chinese authorities for lobbying for him. He owes the pro-Beijing DAB, FTU and agricultural and fisheries subsector members whose votes were crucial to his success. After the election, Leung attended a DAB retreat in Shenzhen to explain his expectations of his administration and listen to DAB members.²⁹ DAB and FTU members are likely to feature prominently in his administration and/or in appointments to influential government bodies, and his manifesto promises to help fishing interests to develop ocean-going fishing.

He owes nothing to tycoons

Equally significantly, he owes nothing to Hong Kong's major property tycoons, who insisted on supporting Henry Tang till the end - most notably, Li Ka-shing of Cheung Kong.³⁰ The question is to what extent CY Leung will change the existing land-supply and public-housing policies, thereby upsetting Hong Kong's economic status quo that favours these interests and the extensive businesses they have built in Hong Kong.

Hong Kong's awkward status quo

Maintaining Hong Kong status quo requires an uncomfortable alliance between the leftist parties and the capitalist tycoons. Thus, there are in fact two ideological groups within the pro-establishment camp in Hong Kong. With the competition between CY Leung and Henry Tang - two patriotic candidates - the divide became all too visible.

Uncomfortable alliance became obvious

In the past, shipping tycoon Tung Chee Hwa already had the support of the capitalist camp, and Beijing ensured he was also supported by the leftist parties. During the Tung era, DAB and FTU members complained that their views were not valued, whereas those from business backgrounds were. In

Henry Tang was seen as providing the desired continuity . . .

. . . but Hong Kong people see the elites' alliance as self-serving

Skewed policies favour high land prices and construction . . .

. . . and artificially capped recurrent social spending hurts the poor and middle class

the case of Donald Tsang, he had the support of tycoons and business, and he could rely on the pro-Beijing parties to support the government when he needed it. Tsang also came to an accommodation with the Heung Yee Kuk (rural land interests) and appointed its chairman, Lau Wong Fat, to the Executive Council.³¹

Henry Tang was seen to favour big business interests and his successful election would have signalled a continuation of the economic status quo. Beijing was believed to favour Tang above Leung at the start of the election campaign, which meant the central authorities also favoured keeping the status quo.

Maintaining the status quo has meant that leftists and rightists have helped to push through policies that Beijing cared about (such as constitutional reform), and that leftist legislators have supported the government's policies even if they were unhappy with the substance, on the basis that harmony and continuity was of utmost importance.

However, a huge schism has developed over the years. The people feel that maintaining the status quo has put Hong Kong in the worse of all worlds:

First, the "us and them" legacy leads Hong Kongers to believe that the dominance of pro-Beijing politicians makes mainland meddling easier, thus compromising Hong Kong's autonomy and way of life.

Second, the richest are getting richer while ordinary people do not share in Hong Kong's economic gains, because the political system and government policies favour commercial interests.

Third, pro-government politicians are seen as stooges of Beijing and establishment interests, because they end up supporting the status quo. The DAB has been vocal about its unhappiness, recognising that it has to be "pro-establishment", which at times makes the party unpopular with the public and disadvantages it at the ballot box.³²

Finally, the status quo holds Hong Kong back, because the vested interests prevent the city from changing.

Land revenue and CWRP

The current administration led by Donald Tsang is seen as embodying policy conservatism that favours high land prices and low social spending. By restricting the supply of land, prices are kept up. This pours huge amounts of land-related revenue into government coffers, which is then put into the Capital Works Reserve Fund (CWRP) to spend on constructing physical infrastructure. Thus, Hong Kong continues every year to dedicate billions to pour concrete (Section 3).³³

Artificial cap on public spending

Yet, the government also puts an artificial ceiling on recurrent public spending, which affects education, healthcare, welfare and the environment, all of which build the software of society. The Hong Kong administration has a declared commitment to keep expenditure at or below 20% of GDP, which affects not only the poor but also the middle class, especially with respect to healthcare and education spending.³⁴

More democracy please

Hence the call for democracy has not ebbed. Because people feel their promised autonomy and democracy are constrained, there is a stronger assertion of Hong Kong's local identify.

Mainland should stop interfering

Hong Kong people are unhappy about mainland interference in their way of life and in slowing down democratic reform. In December 2011, an annual poll carried out by a survey unit at the University of Hong Kong found that only 17% of respondents described themselves as Chinese - a 12-year low - whereas the number identifying as Hong Kongers was at a 10-year high. After its release, an official from the Central Liaison Office said the survey was 'unscientific and illogical', which didn't help matters.

Beijing calls for reconciliation

Call for reconciliation

Previous chief executive elections were set-pieces, where Beijing's preferred candidate was obvious and won according to plan, whereas this year's election became mired in scandals and mutual accusations between CY Leung and Henry Tang. The mudslinging between the two "patriotic" camps made Chinese leaders uncomfortable. Vice-president Xi Jinping called for self-restraint in early March 2012.³⁵

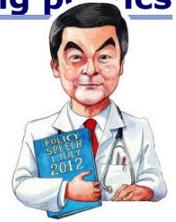
Beijing and Leung spoke about 'deep-rooted conflicts' in social and political terms . . .

After the election, CY embarked on a series of meetings with leading business figures, particularly Henry Tang's supporters, as part of a reconciliation process. He said he wanted to show he bore 'no grudge' against those who did not support him.³⁶ Premier Wen Jiabao also asked Leung to unite and consolidate support from different sectors and eliminate differences and conflicts. Leung's response was that he would do his best to work with different sectors to resolve Hong Kong's 'deep-rooted conflicts'.³⁷

. . . but major changes are needed in policies and political structure

Thus, Beijing is not unaware of problems in Hong Kong. A more intriguing occasion was a meeting in Beijing in early April between the Director of the Hong Kong and Macau Affairs Office of the State Council, Wang Guangya, and a FTU delegation, after which the FTU chairman said Wang expressed expectations that the FTU would support the Hong Kong administration to narrow the wealth gap and response to the calls from the grassroots.³⁸

The question is whether Beijing is willing to change the political system to steer it away from being so dominated by commercial vested interest in the coming years. Does the CY Leung era signal the economic balance of influence in Hong Kong is about to change?



CY has plenty of ideas, but can he walk the talk?

An extensive manifesto

No need for major policy reversal?

'Consult, decide and take action'; criticism of current government

No mention of the peg, or the wider economic environment

Some to please many subsector voters

Five major sets of issues

CY's policy plans

CY Leung is highly critical of the policies of the current government. He clearly wants to change many things, as can be seen from his writings in earlier years. His election manifesto dovetails with his earlier views, which are showcased below in order to get a measure of Leung's ideas. The question is whether he can walk the talk.

CY Leung's campaign manifesto published in March 2012, entitled *One Heart, One Vision*, reflects his thinking and what he aims to do. He consulted a wide range of experts and professionals from December 2011 on earlier drafts on specific policy areas, and his district walkabouts were billed as 'Together we write the manifesto'. He declared in the manifesto that he was not just facing the Election Committee but the people of Hong Kong, and that he would be accountable to them for his promises.³⁹

In the Foreword to the manifesto, Leung emphasises that:

Continued economic development is the foundation of Hong Kong's prosperity, on which the livelihood of our citizens depends. There is no need for major reversal of policy. We only need an appropriately proactive government which seeks changes whilst maintaining overall stability.⁴⁰

This was likely inserted to respond to continuing questions throughout his campaign about whether he would make major policy changes. A key campaign theme was 'Seeking Change while Preserving Stability with Right Way Forward.

In an earlier draft, CY had identified three major areas where he felt change was needed - in government policy ideas, governance philosophy, and executing policies effectively. The document stated 'Consult, decide and take action' as a summary of his thoughts (which could be read as a criticism of the current administration). These words did not find its way into the manifesto.

Where there is silence

Leung's manifesto does not discuss monetary issues. He does not discuss the HK-US dollar link, which is understandable since any mention of this may create an impression that he wants to break it. He is also silent on the wider economic environment, which may impact Hong Kong.

CY Leung's manifesto

Leung's manifesto has something to please many subsector electors, including references to religion (such as establishing commemorative days to honour Confucianism and Taoism), promoting organic farming and assisting ocean-going fishing.

Beyond pleasing voters, his manifesto may be divided into five parts.

1. Population and local resources

CY Leung's main thrust is that Hong Kong should have population and immigration policies which dovetail to prioritise the interests of the local community. This mainly impacts mainland pregnant women wanting to give birth in Hong Kong and mainlanders coming to Hong Kong for family-reunion settlement.⁴¹

**Stop mainland
'birth tourism' -
a popular decision**

Consistent with what he said in his manifesto, CY announced on 16 April 2012 a "zero quota" policy on mainland pregnant women with no connection to Hong Kong giving birth here starting 2013. Mainland women who have a Hong Kong-resident husband may continue to come. While the Donald Tsang administration has imposed a quota (31,000, and was considering a further reduction) to make 'birth tourism' harder, Leung's zero-quota policy is more aggressive. He wants time to reconsider the whole matter in light of Hong Kong's demographic trends, local needs and hospital resources.⁴²

In 2011, almost 44% of births in Hong Kong were to mainland mothers, with 85% of those women with no Hong Kong connection. Some of these were born in private hospitals which charge very high prices, while the rest were in public hospitals. The attraction for mainland women to give birth in Hong Kong is that their babies will have the right to permanent residency, and also that they can circumvent the mainland's one-child policy.⁴³

To take the right of permanent residency away requires legislative change, which has constitutional and rule-of-law implications, and the consequence of various pathways are being debated in Hong Kong.⁴⁴

**Take back control of
immigration policy
vis-à-vis the mainland**

While CY Leung will respect mainlanders applying to settle in Hong Kong for family-reunion purposes, he wants Hong Kong to screen, approve and decide on the timeframe rather than leave it to the mainland authorities (which is currently the case). His manifesto, for example, gives priority to single mothers joining their children in Hong Kong. In other words, he wants to take back immigration control.

His stance on birth tourism is especially popular because Hong Kong people feel their small city and limited service resources can be easily used up by large mainland demand. The Donald Tsang administration is seen as unable to take resolute action.⁴⁵

**Leung will likely pay
personal attention
to land policy**

While his manifesto makes clear he will set-up a new strategic development committee, headed by a senior minister, he will likely pay this area direct attention. Perhaps Hong Kong's major developers are uncomfortable with CY because of his general attitude and the following statements:

Since 2003, the government has replaced regular auctions with land sales by applications, *thus handing over the land supply initiative to developers*. As a result, land supply fell short of demand, leading to shortfall in housing, office buildings, hotels and shops, forcing up prices and rentals, and causing some enterprises to move their business out of Hong Kong.

CY Leung's draft manifesto

Since 2003, the government has replaced regular auctions with land sales by applications, *thus handing over the land supply initiative to developers, who, understandably, would have their own timetable based on commercial considerations*. As a result, land supply fell short of demand, leading to shortfall in housing, office buildings, hotels and shops, forcing up prices and rentals, and causing some enterprises to move their business out of Hong Kong.

CY Leung's manifesto, p. 18

Demography, fertility, diversity, filling jobs

The accepted gospel is that Hong Kong's ageing population and low fertility rate (1.04 per woman) is not enough to replace the population. CY Leung seems ready to promote family-friendly policies, such as his manifesto pledges to give paternity leave and subsidise childcare and kindergartens.

Another way to increase the population is to attract people from outside. Hong Kong has always taken people in, mostly from mainland China, and that continues to be the case today. When the mainland had few opportunities, mainlanders were very keen to come to Hong Kong. Things are changing on the mainland, although today there are many coming to Hong Kong to study and work, while a good number (who tend to be lower-skilled) still come for family-reunion settlement.

Leung's answer to those who say the influx of mainland women giving birth in Hong Kong can help solve Hong Kong's ageing population is that 'such an approach is misconceived. The problems that we, as a community, have to face are more imminent than what such an approach could offer'. He is referring to supply and demand of hospital services in the short term.

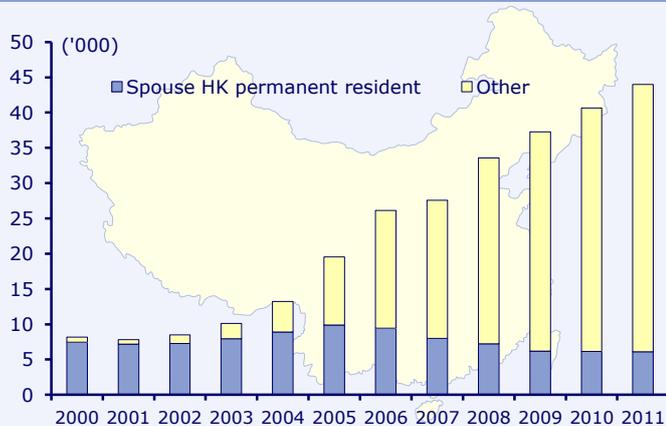
Another imminent problem is a deficit of the right workers. A government study forecasts a manpower shortfall of 14,000 by 2018. The study shows the shortage would not be evenly spread across the workforce - people with upper-secondary and sub-degree qualifications would be in the shortest supply, whereas there would be a surplus of low-skilled workers.⁴⁶ Where will these workers come from at the time they are needed?

The mainland is a source of people, but beyond that is Hong Kong willing to consider immigrants from elsewhere? To attract skilled foreign talent, Hong Kong needs to do more to create a pleasant living environment for people who have location options, which is why cleaning up air pollution has become such a big issue with multinational companies and foreign nationals. Overseas talent look to Singapore, for example, as a healthier option.

The experience of foreign-domestic helpers (FDH) seeking residency rights in Hong Kong shows a difficult aspect of immigration. Hong Kong people do not want them to become permanent residents even though those who may qualify have been working in Hong Kong for a long time. The objections seem rooted in class and money - FDHs are seen as low-skilled (although essential to the economy), and a key concern is if they became permanent residents, they would demand different employment terms that disadvantage employers.⁴⁷

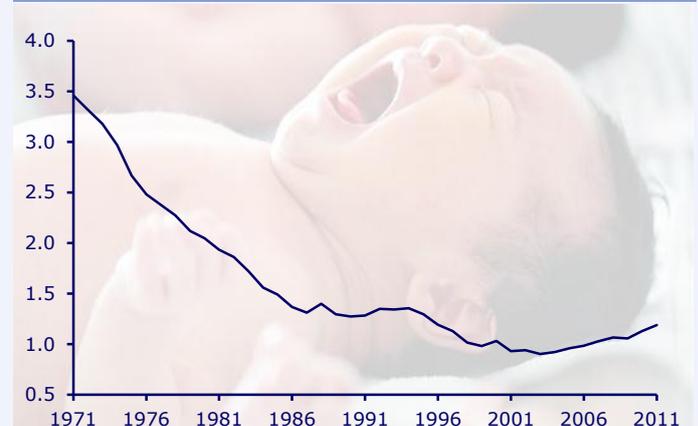
Is Hong Kong ready to be a more multicultural society? Available data shows Hong Kong residents today have quite diverse backgrounds in terms of where they have studied and lived although the vast majority are ethnically Chinese.⁴⁸ Will attitudes change in the next decade among younger Hong Kongers in favour of greater diversity? CY's manifesto mentions helping the children of ethnic minorities in Hong Kong (mainly South Asians) to have better education opportunities - which is right - but is there a step further he is willing to go in the years ahead? Beijing may well have a view too if permanent residency can be granted to a more diverse ethnic mix.

Hong Kong births to mainland Chinese mothers



Source: Hong Kong Census and Statistics Dept, CLSA Asia-Pacific Markets

Hong Kong's total fertility rate



Source: Hong Kong Census and Statistics Dept, CLSA Asia-Pacific Markets

Donald Tsang's October 2011 policy address

Building a government landbank

Tight supply in the short term: developers will keep prices high

Subsidised housing . . . and extending mortgage tax deduction to 20 years

Dealing with the worst dwellings too

Housing Society flats first to be restricted to purchase by locals only

The implication is CY wants to change land policy, although the Donald Tsang administration had already started to deal with land and housing issues more seriously - Donald Tsang devoted a major portion of his October 2011 policy address to them. Taken as a whole, his manifesto shows he will continue the current policies to make more land available for development, redevelop old buildings and old areas, and cut red tape to changing land use. The question is whether he will go further and faster.

CY Leung will also consider reclamation outside of Victoria Harbour because he sees that as a way to build up Hong Kong's land reserves to meet its development needs. His manifesto mentions reclaimed land, land at the border with Shenzhen and developable land in the New Territories, which together could form a government land bank.⁴⁹

New policies will take time to roll out and impact the market. In the short-term, home supply will still be tight and developers can spread out launches of new flats this and next year to keep prices strong.

Housing

Unsurprisingly, CY says housing tops the list of livelihood issues for the general public. His manifesto states private property prices jumped 95% over the past five years, putting ownership out of most people's reach. Rents also rose 48%,⁵⁰ and Hong Kong's poorest end up paying the highest rent on a per-square-foot basis. Meanwhile, applications for public rental housing surged.

In 2011, he had explained the causes thus - a dig at Donald Tsang's policies:

The key factor behind continual increases in prices is that the net supply of private residential properties has been falling progressively in the past eight years. The long term policy response to this must lie in the increase of supply.

CY Leung, Hong Kong Business, April 2011

His solution is for the government to subsidise housing:

The affordability gap has been growing as housing prices have increased at a rate much faster than salaries and wages. Government policies should not aim at bringing down prices to suit affordability but should provide homes for sale at subsidised prices.

CY Leung, Hong Kong Business, April 2011

He will continue the current administration's policy of focusing on building more public rental housing for low-income families and helping middle-income families to buy their own home (for example, increasing various types of home-ownership flats). However his manifesto also pledges to extend the period of tax deductibility of mortgage interest to 20 years and see what can be done to improve Hong Kong's worst dwellings - caged homes, cubicle apartments and sub-divided living units. He will also use Hong Kong's fiscal reserves to make social investments, such as building more homes for the elderly and the disabled.⁵¹

Restrict sale to locals?

Will CY restrict sale of property to local residents? It is happening even under Donald Tsang. The current chief executive's last policy address in October 2011 noted that 'abundant liquidity and persistently ultra-low interest rates', coupled with tight supply of private residential flats, have pushed prices in the private market sky high. He then added that there was also strong demand from mainland and overseas investors.⁵²

Heya Green in Sham Shui Po

Not likely to restrict sale in private market

So far, a new policy in Hong Kong is to restrict the sale of government-built housing to Hong Kong residents only, as a way of reducing speculation in lower-end small flats. The Housing Society, which is charged with building these types of housing, said the sale of Heya Green apartments in Sham Shui Po will be for local residents, and it will not accept corporate buyers. The project is due for completion in 3Q13. If the plan takes effect as expected, this will be the first project to place such restrictions on flat sales in the territory.⁵³ There is also an existing policy that these types of flats have other sales restrictions relating to when they can be resold.

This kind of policy is not unique to Hong Kong. Other jurisdictions have a two-tier property market, for example Singapore and Australia, with segments reserved for locals albeit with differing rules.

The question is whether CY Leung will take things beyond government-built properties into the private market. This would be a major and highly controversial move, which seems unlikely. His manifesto is specific about the public-sector Home Ownership Scheme:

We will study the introduction of a "Hong Kong property for Hong Kong residents" policy to assist those home buyers whose income exceed the limits prescribed by the Home Ownership Scheme. Under the proposed policy, new sites will be selected which are suitable for middle-class housing and in the relevant land lease a restriction will be included to the effect that the completed housing units can only be sold to Hong Kong residents.

CY Leung's manifesto, p. 20⁵⁴

Small-house policy⁵⁵

Land in the New Territories is a sensitive political issue. The Heung Yee Kuk, an Election Committee subsector and Legco functional constituency, will fight tooth and nail to retain it for as long as possible because billions of dollars are involved. The Heung Yee Kuk represents indigenous villagers, which are families from an indigenous resident in 1898 of a recognised village when the New Territories was leased to the British.

The policy was first put in place in 1972 the purpose of which was to persuade the village landowners to sell their land to the government to build new towns. In exchange, the government undertook to give an adult indigenous male villager a concessionary grant to build a "small house" of maximum 700 square foot of maximum three storeys (ie, a maximum 2,100sf in total) in the New Territories during his lifetime, so that villagers could maintain their traditional lifestyle. Small houses are also exempt from building regulations.

Many villagers no longer live in their traditional villages and they have sold their land to non-villagers. The value of small houses has been rising for years and



today they are worth millions. The government had wanted to replace the policy in 1997 but has not pursued it seriously in light of the Heung Kee Kuk's objections.

It is well known that the small-house policy stands in the way of efficient land-use planning in the New Territories. Henry Tang raised the possibility of allowing small houses to go from three to nine storeys so as to reduce the footprint of the policy. The Heung Yee Kuk liked the idea but CY Leung thought the problem needed a better solution, although he was non-specific during the campaign. There is also no specific mention of small houses in his manifesto.

The Heung Yee Kuk originally supported Henry Tang, but towards the last days of the campaign, when it became increasingly clear that Beijing had swung its support behind Leung, the chairman of the Heung Yee Kuk indicated that its members need not fear CY Leung.⁵⁶ It is unclear if some sort of understanding had been reached between CY and the Heung Yee Kuk on small houses and other New Territories-related issues.

Small-house policy - a very thorny problem

Free market, but government to redress imbalance

Another criticism of consequence of existing policy

Many new councils and agencies to be established

Low taxes and balanced budgets are constitutional requirements

Use fiscal reserves, and how about CWRP?

Dealing with social iniquity

There is also the problem of small houses in the New Territories. If it can be resolved, it will help to promote good planning there. He will have to find a way to negotiate with the Heung Yee Kuk.

2. Economic policy

CY Leung wants the free market and proactive government to coexist. He sees it as the government's job to redress the imbalance in Hong Kong's economic structure. Thus, whilst he pledges to raise Hong Kong's status as a financial centre, he also wants Hong Kong's economic base to be widened with government support, because financial and professional services 'provide limited local job opportunities' and the bulk of local consumer-service jobs are low paying.

Thus, greater efforts should go to expanding Hong Kong's shipping, insurance, creative and tourism services. These are not so different from existing policy, but supporting ocean-going fisheries and organic farming are definitely a new direction (and perhaps particularly worthy of support by the Agriculture and Fisheries subsector voters).

His manifesto observes that:

The problem of Hong Kong industries lacking diversification has yet to be addressed properly. High land prices and rents not only push up costs and reduce job opportunities, they also restrain industrial investment and dampen the motivation to start up new businesses. It has been a trend world-wide that the growth in income from property is faster than from wages over the past 20 years. Given that Hong Kong's economic structure is biased towards the financial and property sectors, this trend is particularly evident.

Manifesto p. 24-25

To coordinate and implement new policies, CY Leung will establish and personally lead a new intergovernmental agency on economic development, and his administration may set up a strategic investment agency to back emerging industries (unspecified what these may be), as well as a Financial Development Council. He also wants to find more ways to cooperate with the mainland to benefit Hong Kong businesses.

Taxes, fiscal reserves and land revenues

His manifesto repeats the Basic Law provisions that Hong Kong should practice a low tax policy and to keep expenditure within the limits of revenues and strive for fiscal balance.⁵⁷

What his manifesto does not say is whether his administration will loosen the artificially imposed limit of 20% of GDP on recurrent public spending. It is not inconceivable that he will be more willing to use Hong Kong's vast fiscal reserves (now standing at US\$285 billion) on social spending (stated in CY's manifesto), and to change the administrative practice of putting land-related revenues into the CWRP for capital projects.

3. Improve livelihoods

CY Leung's manifesto contains viewpoints and proposals covering social welfare, education, the environment, healthcare, culture and sports. We highlight welfare, education and the environment below.

a. Welfare

Leung's manifesto states that Hong Kong's per-capita real GDP rose by 33.5% from 1997 to 2009. However, during the same period, the income of the top 10% of households increased by 64.7%, while that of the lowest 10% fell 22.2%.⁵⁸

Increase subsidies for childcare centres and kindergartens

CY recognises the importance of international schools

English Schools Foundation

The now-disbanded government-appointed Poverty Commission had noted that poverty was a serious problem in Hong Kong. The commission calculated that Hong Kong had 759,900 people living in poverty in 2010.⁵⁹ An Oxfam report published in 2011 showed one out of every six poor families could not meet their basic food needs.⁶⁰

CY Leung will reinstate the Commission on Poverty to review policies and identify measures to help the disadvantaged,⁶¹ and his manifesto lists a chain of initiatives to provide for the disadvantaged.

b. Education

Leung's manifesto promises to increase subsidies for childcare centres and kindergartens, which is popular with families with young children.⁶² While his manifesto does not say it, he would do well to bring kindergartens into the school system, which would increase recurrent expenditure but would be the right way to go if he is serious about improving education for Hong Kong people.

His manifesto recognises there are not enough international-school places in Hong Kong to cater to local parents who want their children to have such an education, and also provide for the children of foreign nationals working and living in Hong Kong, which is a good start.

A key decision will be what to do with the partially-subsidised English Schools Foundation (though the ESF's subsidy has been frozen for many years) - there has been talk by the current administration of possible privatisation, which would result in much higher fees. CY Leung is on record saying "I support continued subvention to ESF", thus the issue of the ESF's future should be resolved.⁶³

Land, Taxes and Capital Works Reserve Fund (CWRP)

Hong Kong's political economy centres on land. From the early colonial days, the British administration put in place a system where it could use land to generate government revenue. The government is the sole freeholder of land and it sells leaseholds. Leasehold extension and change of land use require payment of a land premium (ie, a tax). Land revenue from land sales, lease extensions and change of land use has always provided a good chunk of government income. The revenue contribution from land is even higher if stamp duty and corporate tax from property companies are included.

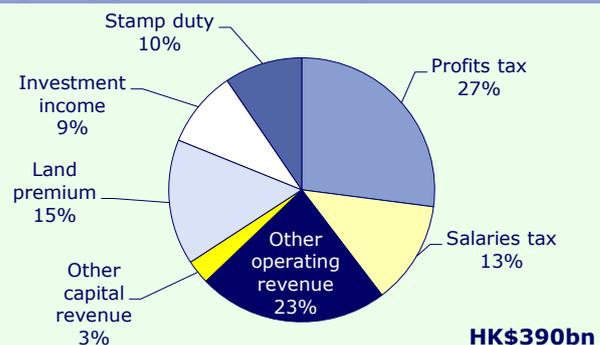
The government is thus able to keep direct taxes low because it can draw on land as a major source of revenue. In 1982, during the time of Sino-British negotiations over Hong Kong's future, the Chinese were concerned that Britain may take Hong Kong's healthy fiscal reserves away. A deal was made that land revenue had to be used in Hong Kong. Land revenue has since been placed in the CWRP, which is used for local capital works. This is the reason why Hong Kong can always find money for pouring concrete.

Land premiums are charged upfront - ie, before development begins - and calculated based on the value of a development when completed. This means

developers have to finance a hefty upfront tax. This gives the major developers with deep pockets the advantage. It also means property is expensive.⁶⁴

Previous administrations should have increased land supply earlier but slow reactions led to property prices climbing substantially. Local residents used to spend about a third of household income on housing but they are spending nearly half today. Donald Tsang's last policy address in October 2011 devoted a substantial part to land and property issues as public complaints mounted. High property prices act like an indirect tax on the people of Hong Kong.⁶⁵

Hong Kong government revenue, 2012-13



Source: Budget speech, CLSA Asia-Pacific Markets

**Diversity in education is
the way to go**

The ESF has a strong reputation for providing a solid international education in English to thousands of mostly middle-class Hong Kong Chinese families, whose children make up the majority of its students. The school also provides education to the children of foreigners working in Hong Kong. The ESF has a long queue of applications - in other words, demand outstrips supply. Its fees are lower than other international schools because it receives a government subsidy. Over the years, the government has not been able to decide how it should position the ESF going forward - should it continue to subsidise the ESF schools and accept it as part of the Hong Kong school system providing an international education in English, and if so, by how much? Or is there a case for privatisation (which would bump up fees substantially)?

As Hong Kong has solved the problem of providing basic education at the primary, secondary and tertiary levels, the next step is to improve the quality and choice, as well as fill in gaps in early education, special education, and improve the learning experience for students with disabilities. From the overall tone of his manifesto, CY should be willing to consider diversity and quality in developing Hong Kong's education system further, although he will need a clear-headed education minister to push on many fronts.

c. Cleaning up the environment**A typical set of ideas**

Like most politicians, CY Leung's environmental policies refer to 'striking a balance' between economic development and environmental protection instead of redressing the imbalance in favour the environment where necessary.⁶⁶ As noted above, he is able to speak about redressing the imbalance in terms of the free market versus government action, but not with respect to the environment. He also sees improving environmental conditions as part of improving the quality of life of residents and not from the perspective of strengthening ecosystems and building environmental resilience because they provide the foundation of life. In short, he is typical rather than atypical as a policymaker as far as the environment is concerned.

An urgent matter as waste mounts

He is likely most concerned about waste management because he already knows he has to deal with whether Hong Kong should spend HK\$23 billion to extend landfills and build a giant incinerator as soon as he takes office. Legislators refused to endorse the current government's plan in April 2012 because they prefer to wait for his administration and the new Legco elected in September 2012 to deal with it.⁶⁷ Building an incinerator and extending landfills are important near-term measures because Hong Kong's landfills are almost full. However, Hong Kong needs to reduce all types of waste at source to solve the problem long-term. Taipei and Seoul have made impressive efforts, so there is no reason why Hong Kong cannot do it, but it requires the government to work with business and the public in changing behaviour, something successive administrations have not been able to do. CY Leung has looked at results in Taiwan, so he knows much more can be done - such as in food waste, but he needs policy leadership and a lot of elbow grease to reduce waste. He will also have to introduce waste charging.

Space for pollutants from third runway needs major reductions

He is also aware that air quality is poor but has yet to appreciate that to make significant improvements he has to truly use public health as the yardstick to measure the success of government initiatives. In fact, the mainland has clearer policies than Hong Kong - it has tightened air-quality standards to drive change, whereas Hong Kong officials have always wanted to set standards that their initiatives can meet, rather than get

tough on polluters. Thus, their plethora of measures has reduced pollution levels somewhat but not nearly enough if measured in public-health terms. CY Leung's manifesto does not appreciate this. There is urgency to act though - the Airport Authority wants to build the third runway (and so does CY) but assessments shows the additional pollutants generated will make the project fail its environmental-impact assessment. This means the government will have to reduce pollutants beyond what the Airport Authority can do on its own.

In his manifesto, Leung states that he is willing to use Hong Kong's fiscal reserves to make 'economic investment such as building the third runway at the airport', and in another part of the same section he says he is willing to use the reserves to improve air quality.⁶⁸ What he needs to do is to combine the two thoughts in a way that allows Hong Kong to continue to develop and at the same time reduce air pollution, as California has successfully done. California achieved this by prioritising public health, carrying out solid research to guide evidence-based policies, setting the toughest standards and ensuring enforcement.

Nature conservation

This is an area where CY Leung has taken a personal interest in the past. He has looked at using conservation trusts to protect rural land of high ecological value and he has had experts to advise him. Surprisingly, his manifesto does not reflect the work that he had done in this area. However, it does pledge to 'review the social value of the agricultural industry in Hong Kong' and to set up an 'inter-departmental group to formulate policies to promote and support multifunctional agricultural activities on land suitable for agriculture', as well as to establish a fund to retrain fishermen for 'new methods of sea-based operations, and promote sustainable usage of Hong Kong waters'.⁶⁹ As noted above, his manifesto also promises to subsidise ocean-going fishing. All of these promises presumably helped to swing the Agriculture and Fisheries subsector's votes behind him.

4. Better governance

CY Leung wants to increase the number of ministerial and political appointees, thus putting in place a much larger executive team.⁷⁰ As the current and Leung administrations are cooperating for a smooth transfer of power, the office of the chief executive-elect put a reorganisation package to the current government, which has been approved by the current Executive Council (ExCo), but it still has to gain funding approval from Legco so that the new team can be paid from 1 July.

The extra funding request amounts to HK\$72 million a year in staff costs for at least 57 posts, including a deputy chief secretary, deputy financial secretary and two new ministers, two undersecretaries plus various aides. It is likely the funding proposal will pass, since otherwise the setting-up of the posts that are not currently in existence could be delayed for several months, given that the new Legco will not take up office until early October.⁷¹

Leung thinks the Executive Council is not functioning optimally and the role of non-official members (those with no ministerial portfolio) is 'essentially passive'. He may call for more regular meetings (currently once a week and a total of about 40 meetings a year), and placing non-officials to head important consultative and executive public bodies, such as the Housing Authority (provide public housing), Hospital Authority (provide hospital care) and the Securities and Futures Commission.⁷²

Bigger executive team

Harder working ExCo

Wait to see quality of ministerial appointments

A small but important test - sort out records management and archiving

A larger team does not necessarily lead to better governance. The quality of policy and implementation will depend on the quality of his ministerial team. The head of his chief executive-elect office said the team is expected to be announced at the end of May or early June.⁷³

A small test (of major long-term consequence) of whether the CY Leung administration will do what is necessary for better governance may be seen in what he will do with the government's archives. Hong Kong is unusual in that it has not passed an archival law, and its organisation, management and archiving of official records is poor by comparison to the mainland and many of its Asian neighbours. For reasons never explained, the Hong Kong authorities, pre- and post-1997, have not acted on an issue which should be a matter-of-course. They have insisted that a code of practice is sufficient, when many incidents have showed that files have not been kept or protected, or could not be found, to the government's detriment. Public bodies, such as the Housing Authority, Hospital Authority, Urban Renewal Authority etc, are not covered by the code.⁷⁴

Figure 8

Ministerial structure: Current



Figure 9

Ministerial structure: CY Leung's proposals



Source: Hong Kong Government

The likely chief functionaries: John Tsang and Carrie Lam



Likely chief secretary: Carrie Lam Cheng Yuet-ngor was born in Hong Kong in 1957. She went to St Francis' Canossian College before attending Hong Kong University, where she graduated with a Bachelor of Social Science in 1980. She joined the Administration Service in the same year, staying for 27 years until she became a Principal Officer in 2007.

Lam served in a variety of posts within the government, including director of social welfare and permanent secretary for housing, planning and lands. Between 2004 and 2006, she served as director-general of the HK economic and trade office in London, and she returned in 2006 as permanent secretary for home affairs.

Lam has served as the secretary for development since 2007. She is nicknamed as a "powerful fighter" in the local media, as she was successful in promoting the government's agenda in controversial issues such as demolition of Queen's Pier in 2008 as well as recently talking tough on illegal structures on New Territories village houses. She was consistently ranked as one of the most popular ministers according to Hong Kong University's Public Opinion Programme (POP). In the latest April 2012 survey, 62% of respondents supported her reappointment and only 10% voted for dismissal.

She is married with two sons, both currently studying in the UK. She is one of the two members of the Executive Council who does not own property in Hong Kong, according to her annual declaration filed in 2011.

As a possible candidate for the chief secretary for administration, Lam would be the second most senior official.

Duties of chief secretary include:

- ❑ Assists the chief executive in supervising the policy bureaux as directed by him.
- ❑ Key role in formulating and coordinating policy formulation and implementation.
- ❑ Covers specific priority areas of the chief executive's policy agenda. Is responsible for forging a closer and more effective working relationship with Legco and for drawing up the legislative programme.
- ❑ Exercises statutory functions, such as those concerning the handling of appeals and certain public bodies.



Likely financial secretary: Born in Hong Kong in 1951, John Tsang Chun-wah attended La Salle College in Hong Kong and later moved to New York City where he studied at Stuyvesant High School. Tsang initially pursued his interest in architecture at MIT and went on to receive a Master's degree in Bilingual Education from Boston State College and a Master in Public Administration from Harvard University.

After completing his education, Tsang worked in the Boston public schools system prior to returning to Hong Kong and joining the administrative service in 1982. He served in the trade department, then as assistant to the financial secretary, and as private secretary to then-governor Chris Patten in 1995-97.

After the handover, Tsang moved to London and was appointed director-general of the economic and trade office. Tsang returned in 1999 and was appointed as commissioner of customers and excise, followed by secretary for housing, planning and lands and then secretary for commerce, industry and technology from 2003. In December 2005 he chaired the WTO Ministerial Conference, which was met by over 10,000 protesters. He was then appointed as the director of Donald Tsang's chief executive office in 2006.

From 2007 he has served as financial secretary in Donald Tsang's second term, and is expected to hold this position under CY Leung.

Tsang has an average approval rating among principal officials, according to surveys by Hong Kong University's POP. His 2011 budget could be the low point in his political career. People were dissatisfied by the levels of income inequality and Tsang's refusal to give a tax refund in spite of a record fiscal surplus. Instead, Tsang offered to inject cash into the MPF fund. Subsequently, Tsang was forced into a U-turn and set up the controversial scheme under which the government gave HK\$6,000 in cash to each holder of a Hong Kong ID card.

Tsang is married with two children.

Duties of financial secretary include:

- ❑ Oversee, formulate and implement policy in financial, monetary, economic and employment matters.
- ❑ Responsible for annual government budget.
- ❑ Chairman of the Exchange Fund Advisory Committee.
- ❑ Effective overall authority over the SFC.

Source: Hong Kong Government

Major environmental gaps to be filled

What CY Leung's manifesto does not do is to show an understanding that the environment is fundamental to development, restoration can be an important economic activity, many jobs can be created, energy policy is critical because of availability, price and that it is intimately connected to improving air quality and mitigating climate change. There are opportunities to improve Hong Kong's energy efficiency as a way of stimulating economic benefits and generating new service-sector jobs, and waste management can also provide a large number of jobs for low-skilled workers. Indeed, environmental improvement at the infrastructure-building and retrofit end, as well as at the low-skill end, can both be articulated as part of his economic and social policies rather than be disconnected from them.

There is also no thought of Hong Kong staking a claim in the financial area of climate change. Hong Kong has already missed the chance to ask China to propose to the UN for the new Green Climate Fund's office be located in Hong Kong, although CY may still consider whether and how Hong Kong could play a role. The fund is to help mobilise US\$100 billion per year to lower carbon emissions.⁷⁵

Energy, nuclear, gas prices and CO₂ targets

In 2010, the current administration proposed reducing Hong Kong's carbon intensity by 50-60% by 2020, which will mainly be achieved through changing the electricity fuel mix from 50% coal, 23% nuclear and 27% natural gas to 50% nuclear, 40% natural gas, about 3% wind and 7% coal. Post-Fukushima, the current administration has yet to express a further view on the way forward, likely because green groups object to buying more nuclear power and Beijing has yet to publish its new policy on the expansion of nuclear on the mainland. Leung's manifesto says Hong Kong must 'study and set a target' for carbon reduction by 2020 'and devise an all-round action plan'.⁷⁶

Fuel switching is essential to lower Hong Kong's carbon emissions. CY will have to take a view on whether Hong Kong should import more nuclear electricity from Guangdong, which is expanding its capacity in this area, and Beijing has in principle agreed to provide more nuclear electricity to Hong Kong should it want it. Hong Kong has been importing nuclear electricity from the Daya Bay plant - a joint venture between Guangdong and CLP Power - since 1994. The Fukushima accident in 2011 has raised questions once more around the world on safety issues, not so much from a nuclear-engineering perspective but from a 'black swan' perspective of non-technical failures. Not buying nuclear electricity from Guangdong does not guarantee nuclear safety for Hong Kong, since there are already six reactors close by at Daya Bay and Ling Ao.

To truly ensure the highest standards of operational transparency and safety, as well as to deal with possible non-technical failures (such as those in Fukushima), it is in Hong Kong's interests to work closely with the Guangdong and national authorities as good neighbours no matter what. So far, Daya Bay has proven to be a reliable and well managed nuclear supplier, and no doubt further improvements are possible especially if Hong Kong and the mainland can come to agreement on even higher standards of all-round safety. Not buying more nuclear electricity does not in itself improve anything for Hong Kong. CY Leung will need to get to grips with this and deal with green groups' ideological objections to nuclear power.⁷⁷

CY Leung's administration will need to put forward new fuel-mix options and provide full information for public discussion on their relative merits with respect to mitigating carbon emissions, improving air pollution, public-health benefits and avoided costs, supply availability of fuels and costs of electricity, etc.

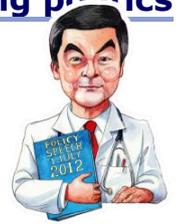
HK-PRD regional collaboration

CY's manifesto rightly mentions in many areas the importance of the Pearl River Delta (PRD) to Hong Kong. When viewed as one geographical area, Hong Kong, the PRD and Guangdong have many areas where they can cooperate in terms of the environment, all of which can strengthen the region's ecosystems; better protect air, water and soil quality; advance in research, technology and application to problems; as well as to develop emissions-trading pilot systems for air pollutants and carbon (Shenzhen and Guangdong are piloting emissions trading, but the Hong Kong administration has paid this area no attention).

Daya Bay and Ling Ao nuclear plants



Source: CLSA Asia-Pacific Markets



Strategy to engage the people paid off

CY did better than Henry Tang, but large numbers were ambivalent about all candidates

Personal popularity

The population

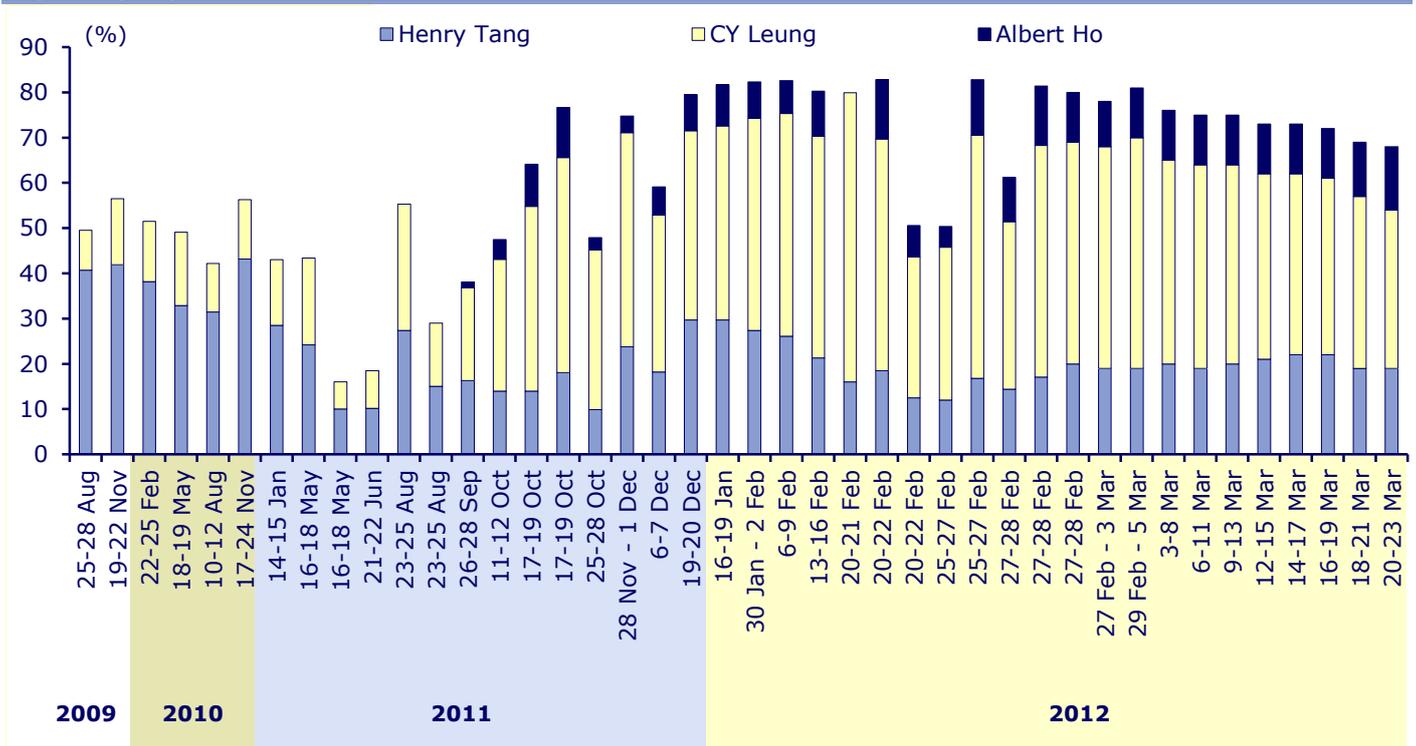
One of Beijing's stated criteria for an acceptable chief executive was that he should be popular. This became the Trojan house of the election and CY took it seriously. Besides lobbying Election Committee members, he tirelessly cultivated relations with many groups in society even ahead of his public declaration to stand for election. He did not start off leading the public popularity polls but his strategy eventually paid off.

Polling data

The Public Opinion Programme at the University of Hong Kong has tracked the popularity of likely chief executive candidates since 2009. Figure 10 shows that in mid-2009, Henry Tang's popularity was considerably higher than CY's. Tang's poll ratings began to drop in 2011, while Leung's picked up significantly by 3Q11. Although there was a drop in Leung's ratings days before the vote on 25 March 2012, Tang's ratings never rose again. Instead, members of the public who had no preference for any of the candidates hovered at around 20% for much of the time since late-2009, and rose to 32% just before the vote. This should provide a sobering reminder to CY Leung that a large number of Hong Kongers were ambivalent about him.

Figure 10

Popularity of potential candidates



Source: POP HKU, Civic Exchange and CLSA

Mock polling results showed 54.6% abstained

The POP also set up *PopVote3.23*, a mock poll on 23 March 2012 for the public funded by public donations. The voting platforms had various physical polling stations dotted around Hong Kong, polls for students at schools, plus online voting via phone and the internet. While the poll faced massive systemic hacking and disruptions for online voting, nevertheless, 222,990 people still managed to vote with 85,154 via the internet, 71,831 by phone, and 66,005 cast physical votes over a two-day polling period.⁷⁸

Post-election polling

Hong Kong mock poll

People also unhappy with the election process

CY takes office as Legco election campaigning begins

Between 27-30 March, POP conducted a final telephone poll and the results were that CY Leung had 35% support, Tang 19%, Ho 14% and 32% did not support any of the three candidates. Thus, Leung's approval rating could not be said to be high.⁷⁹

Figure 11

POP mock polling result 23-24 March

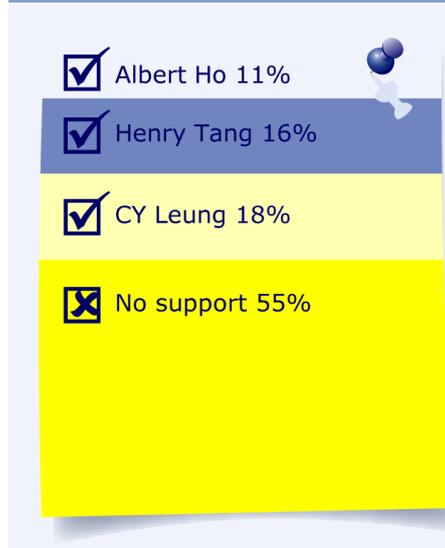


Figure 12

POP phone survey 27-30 March



Source: POP HKU

Robert Chung, Director of POP, observed that the survey showed CY Leung's approval rating stood at 38% and disapproval rating at 51%, giving a net popularity of minus 13%. The poll showed that nearly 60% were dissatisfied with the election process - a much higher percentage than in 1996, 2005 and 2007 on previous chief executive elections.

Starting from mid-April, POP has been releasing popularity data of Donald Tsang and CY Leung together and will continue to do so every fortnight till 30 June 2012 when the current chief executive steps down. The poll results for 17-23 April showed CY's approval rating increased to 48%, which was better than Donald Tsang.⁸⁰

As for the people's confidence in Hong Kong's future, most respondents thought that CY Leung's election had no effect on their overall confidence. The rate was similar in 1996 and 2007. However, when Donald Tsang succeeded Tung Chee Hwa in 2005, 81% believed Tsang would do a better job. With Leung replacing Tsang, the percentage of people who thought Leung would do a better job was 47%.

The survey showed older people were more supportive of CY Leung, and they were also more satisfied with this year's election process. However, overall, Hong Kong people were more critical of the 2012 chief executive election than on previous occasions.

The legislature

CY Leung takes office as Hong Kong's new chief executive on 1 July 2012 and gives his first official speech that day on his policy vision. He will have his ministerial team in place so people can assess the quality and capability of his

CY likely a major campaign subject

New Legco will be like nothing before it

Watch out for five new "super seats"

CY Leung may have competition for legitimacy

key lieutenants. He will have a top-level Chinese leader in town to witness the process and commemorate the start of the 15th year of Hong Kong as a Special Administrative Region.

The celebration will take place just when Legco winds down its current term of office and politicians get ready for the next legislative election in September 2012. The new Legco will begin its term in early October, when CY Leung will deliver his first full policy address, and when much will be expected of him on delivering his many election pledges.

CY Leung is an election issue

The Legco election will take place at a time of heightened attention to CY Leung as the new chief executive. Everything that he says and does will likely be magnified by the upcoming election. CY will be the subject of this year's election campaign, ranging from showing support for his policies, such as from the DAB and FTU, to debating his approach to policies, such as over the "zero quota" for mainland mothers giving birth in Hong Kong by the pan-democratic camp, to calling for him to step down by the more radical politicians of the League of Social Democrats, as well as People Power.

The 2012 Legco

The 2012 Legco will be like no other before it. The current Legco has 60 seats - 30 elected by five large geographical constituencies and 30 by functional constituencies. The problem today is that those elected by geographical constituencies are seen to have greater electoral legitimacy than those elected by functional bodies, some of which are small and some with corporate voters. The 2012 election will elect an additional 10 legislators, taking the size of the chamber to 70 legislators. Five seats will be geographically elected, which means 35 seats in total will be elected directly by the people. As for the other five seats, they have been allocated to the District Council functional constituency.

Five "Super Seats"

There is something very special about these five District Council functional seats: only district councillors elected in 2011 can stand for them, and they run on a Hong Kong territory-wide basis. Thus, their electoral base will in fact be the whole of Hong Kong. This also means these five District Councillors will end up also being legislators. These seats have been described as "super" seats because of their special status in the political system.

In effect, there will be three kinds of representation in Legco from this September: there are five "super" legislators who can claim territory-wide representation, there are 35 legislators elected via five large geographical constituencies who can claim wide representation, and then there are 30 legislators chosen from traditional functional elections, most of which have narrow or extremely narrow representation dominated by vested commercial interests.

The political parties are looking at fielding their best known and most popular District Council candidates for the five "super" seats, since they need wide appeal to win. This also means these five legislators can claim they have territory-wide support. Indeed, these legislators can claim they have wider legitimacy than CY Leung, and they may be potential future chief executive candidates in 2017.

Unholy alliance of anti-Leung forces?

Anti-Leung forces

Will there be anti-Leung forces in Legco? Will the DAB and FTU work closely with CY Leung, thus giving him a reliable support base in Legco? The DAB and FTU have supported Tung Chee Hwa and Donald Tsang reluctantly at times. Will they find working with CY Leung easier because their views are more similar?

Then there are the democrats, who will watch CY on civil liberties and democracy issues, and the business-minded legislators who may well be ready to pounce on issues they don't like. Will the democrats and the commercial functional constituency legislators form an unholy alliance of sorts?

Democracy and liberal way of life

Two unavoidable issues

Two issues CY cannot avoid now that he is in power are his plans and timetables for electoral reform, and for rolling out Article 23. These will be raised not only during election campaigning but will also be a major issue during the course of Leung's term of office. How he deals with them will determine his relationship with legislators and the public.

The unavoidable issue will mark the style of his administration

1. Constitutional reform

The following question was put to CY Leung in February 2012 on constitutional reform:

The people of Hong Kong have been promised universal suffrage in the chief executive election in 2017 at the earliest. What is your plan to open up the nomination process fairly to all candidates and when do you plan to eliminate the functional constituency seats in Legco?

His response was procedurally-focussed, careful not to excite Beijing, and reflecting the utterances of mainland officials:

The precise electoral models for election of the chief executive by universal suffrage in 2017 and the subsequent election of all legislators by universal suffrage have to be settled in accordance with the five-step procedure for constitutional reform determined by the Standing Committee of the National People's Congress (NPCSC) in 2004. The first two steps are to determine whether there should be any change in the electoral system. Once the NPCSC has given the green light, we can initiate discussion on the desired changes. People of Hong Kong have strong and diverse views on the nomination "threshold" for chief executive candidates and the future of functional constituency seats in Legco. These can only be resolved through public debate within the established parameters.

In his speech in Hong Kong in June 2010, Qian Xiaoyang, vice-secretary of the NPCSC and chairman of the Hong Kong Basic Law Committee, acknowledged that "universal suffrage" implies universal and equal electoral rights. He also pointed out that the future electoral system should be consistent with the legal status of the HKSAR and its executive-led political system, should be conducive to the development of Hong Kong's capitalist economy and should take into account the interests of all social classes. The last point lies at the heart of the aim of functional constituencies, which is to ensure the views of major sectors of the community are adequately reflected in Legco discussion.

If I am elected I will initiate discussion as soon as practicable to allow time for more thorough discussion and consensus building on the direction and pace of constitutional reform. The main consideration in determining the nomination threshold would be to maintain a balance between “the right to stand for election” and “a manageable number of chief executive candidates”. As regard functional constituencies, the interim direction of change would be to expand the electorate, to increase members’ representativeness and to make them fully accountable”.

SCMP, 27 February 2012⁸¹

He is noncommittal on details

Noncommittal on details

CY Leung was noncommittal on the nomination threshold for chief executive candidates for 2017, and he indicates functional constituencies may be reformed through enlarging the electorate to something bigger and perhaps bring in more sectors of people.

Will nominating body look like subsectors?

Election Committee to nominating body

Bearing in mind that the current Election Committee both nominated and elected CY Leung, that in 2017, there will not be an Election Committee but there will be a nominating body. The question is whether the future nominating body will look very much like the Election Committee. Bearing in mind again that the subsectors and functional constituencies are very similar, and if the functional constituencies are expanded as CY suggested above, whether this will also expand the subsectors for the new nominating body.

In his election manifesto, the section on constitutional reform is short and adds nothing new to the more extensive reply above except he makes it clear that appointed seats to the District Councils will be abolished at the next election in 2016 (currently 68 of the 507 seats are appointed).

Electoral arrangements for 2017 need to be in place by summer 2016

The question is whether he will lay out a timetable on 1 July when he takes office that the first of the five-step process will start within his first year. If he does this, it will undermine attacks on his sincerity. If he says his priority is to first deal with socioeconomic issues, he opens himself up to criticism for being insincere in promoting democracy. The reality is that there is not much time to consult, negotiate with Beijing, draft legislation for the 2017 chief executive election and get Legco to pass it before it retires for its next election in 2016.

Article 23 raises fears of civil-liberties diminution

2. Return of Article 23?

Article 23 of the Basic Law requires Hong Kong to pass its own laws to prohibit treason, secession, sedition, subversion against the Central People’s Government, theft of states secrets, foreign political organisations or bodies from conducting political activities in Hong Kong and local bodies from having links with foreign political organisations or bodies. Hong Kong people worry that its passage will affect their liberal way of life.

In 2003, the Tung Chee Hwa administration tried to push through draft legislation that galvanised over 500,000 people to protest, which eventually led to the proposed legislation being shelved. When Donald Tsang took over as chief executive in 2005, he said it was not his priority to revive the matter.

Hong Kong needs consensus first

Leung: not my priority

No timetable . . . for CE to decide

When Article 23 comes up, government should be patient to consult and discuss with community

Beijing’s view in 2011

What will CY Leung do? In June 2011, Beijing’s head of Hong Kong affairs, Wang Guangya, said: ‘Hong Kong should introduce [Article 23] ... when everyone reaches a consensus’, and that he would leave it up to the next administration to decide whether to take up the matter.⁸²

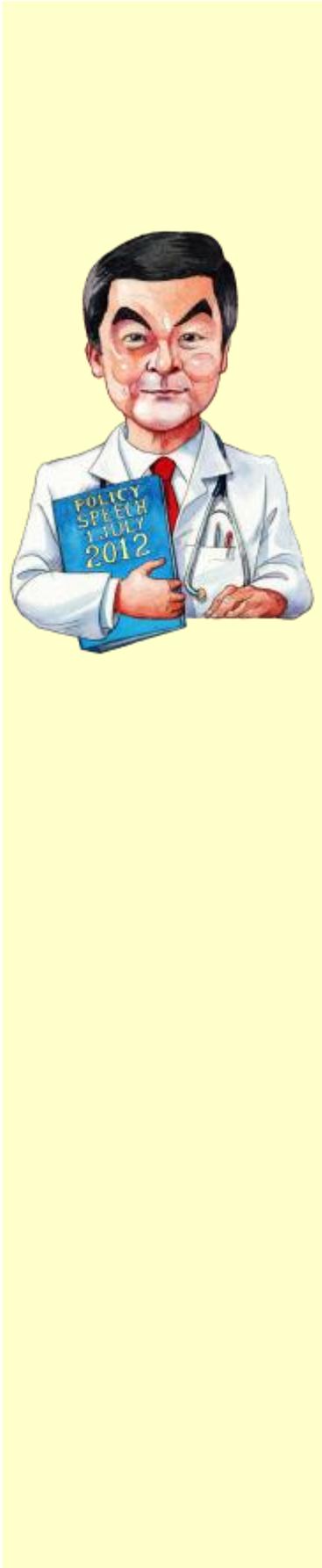
On 27 March, two days after his election, CY Leung said introducing Article 23 was not his immediate priority. He said there were many other economic and livelihood issues that he needed to address ahead of Article 23. He did not say whether he would consult the public on the issue but expressed the hope of eventually obtaining a consensus.⁸³

Beijing’s view in 2012

In early April 2012, Wang was quoted by the FTU’s chairman after a meeting in Beijing that there was no timetable for legislating Article 23, which would first require a consensus to be reached in the Hong Kong community.⁸⁴

Thus, CY is not saying he won’t do it but he insists it is not what he will do now. It seems Beijing is not pushing for an immediate timetable and will leave it to Leung to decide whether and when to consult the public so that a “consensus” can be reached. It would make sense for CY Leung to let sleeping dogs lie.

In any event, there have not been any problems that endangered national security that Article 23 envisages over the past 15 years. Even before the transfer of sovereignty, the departing British administration had put forward draft legislation to address Article 23. The then Legco decided not to pass it on the basis that it was better not to do anything at all. Then in 2003, the Tung Chee Hwa administration put forward another version that was eventually withdrawn from Legco after the massive 1 July protest, as the government did not have enough votes to get it passed. Thus, Hong Kong has had two rounds of discussion on content already. The next time round, greater patience with consultation and community discussion will help.



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CLSA Viewpoint

Property: Stay away from residential players



Nicole Wong
Head of Property Research

CY Leung's taking office on 1 July should mark the end of an unusual period for the Hong Kong property market: a bear-market land-supply mechanism fuelling exceptional price growth in a bull market. And if all-in returns on major developers' shares from 2000 to 2010 had averaged just 6-8% annually despite phenomenal property-price growth, we see little reason to own these stocks in the next five years and are Underweight Hong Kong developers. There are stronger growth and hence return prospects to be found in Hang Lung, Wharf and HKLand.

Between 2000 and 2010, Hong Kong's property market, and in particular residential, had enjoyed an exceptional period of growth. Property prices responded to a tight land-supply policy by running way ahead of income and wealth. The landscape will soon change with the pro-supply Leung assuming office. And if the major developers' all-in returns (including dividends) between 2000 and 2010 were merely 6-8% pa, or just marginally better than the passive and diversified Tracker Fund's 5%, we see little reason to hold these names in the coming years.

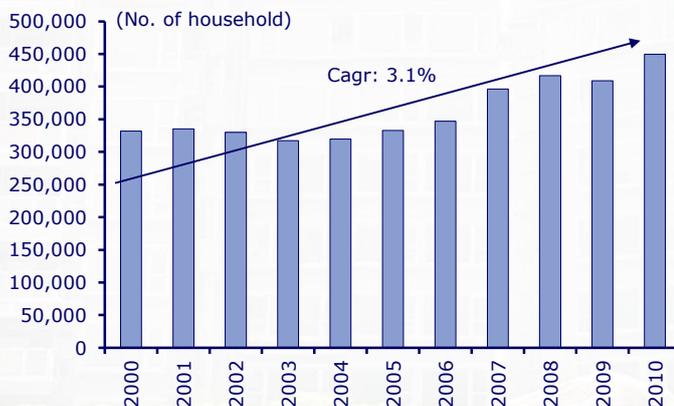
A remarkable 10 years in the property market
The decade up to 2010 had been an exceptional period for the Hong Kong property market and residential in particular, with a bear-market land-supply mechanism in a bull market.

A remarkable 10 years in the property market

The decade up to 2010 had been an exceptional period for the Hong Kong property market and residential in particular, with a bear-market land-supply mechanism in a bull market.

The number of local middle-income households grew at a 3.1% compound rate between 2000 and 2010.

No. of households earning HK\$40,000/month or more

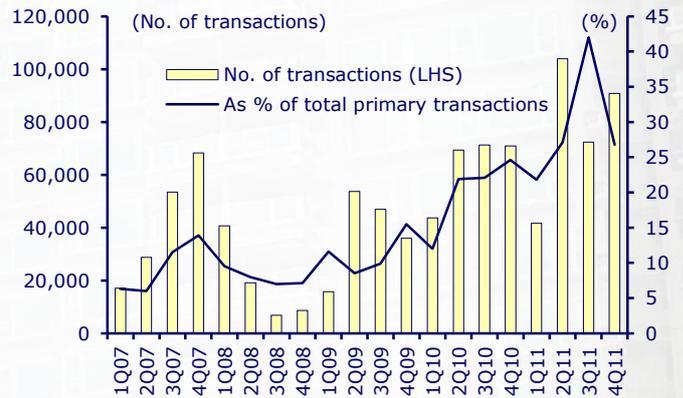


Source: CEIC, CLSA Asia-Pacific Markets

Mortgage rates meanwhile fell dramatically from 7% in 2000 to 2% in 2010 as a result of the July 2001 abolishment of the interest-rate agreement by Hong Kong's banks and aggressive US rate cut after the dotcom bubble burst. An influx of mainland property buyers further topped up local demand from 2007 onwards - their numbers expanded at a 13% Cagr and by end-2010 they accounted for 25% of sales of brand new properties.

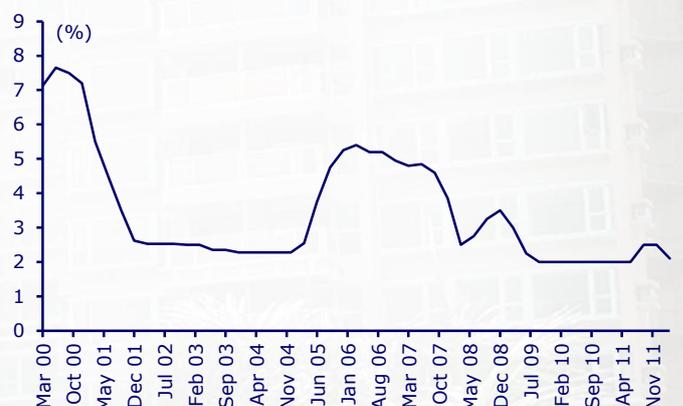
But as demand grew, supply plummeted as result of the Hong Kong government shifting in 2002 to a bear-market mechanism, where land auctions can only be triggered when a developer enters a bid meeting a minimum acceptable price. New residential units increased at only a 1.7% Cagr between 2000 and 2010 - just half the rate of growth in the number of local middle-income households. Residential prices rallied as a result.

Mainland Chinese buyers' participation rate in Hong Kong



Source: Centaline

Mortgage rate



Source: CLSA Asia-Pacific Markets

But less remarkable return in stocks

Returns on major Hong Kong developers have been unremarkable considering the strong performance of the property market. Between 2000 and 2010, annual all-in returns (including dividends) were just 7.7% on SHKP, 5.7% in Henderson Land and 6.8% in New World (we have excluded Cheung Kong, where associate Hutchison booked a record HK\$110bn profit in 1999 after selling Orange, boosting its 2000 share price) - only marginally above the diversified passive Tracker Fund's 5.4%.

The major developers' returns were constrained by the maturity and hence weak organic growth in demand in the Hong Kong market. While residential prices were 66% higher in 2010 than in 2000, demand in quantity (using completion as a proxy) declined 48% during the period. Developers have been able to grow margin, but not revenue.

The above translates into:

- 1) Drag on earnings/NAV growth due to the shrinking scale of the Hong Kong residential market (prices have gone up, but the number of residential units produced has plummeted);
- 2) A derating of multiples, as the discount to NAV widens. This we believe is in part a reflection of the market's view of the future growth rate.

New chief. New era.

Leung has a long-time reputation for being pro-supply and proactive. Below was the extract of his comment on land supply when we interviewed him back in 2009 for the Retrovision report (for the full interview please refer to the "Retrovision" published October 2009):

CLSA: Do you agree that Hong Kong has more land than what consensus believes, and there is room to better utilize land resources?

CY: Yes, land in Hong Kong is not fully utilized. Some of the rural land reservation in the past was due to water catchment purposes. But with Hong Kong fulfilling most of its water demand by imports from the mainland, this is no longer relevant. Also some country parks became country parks in the past because they were not needed. Physically speaking some of these land can be turned into living space for many Hong Kong people who needs more elbow space.

Public opinion has also changed in recent years. And there are many voices for lower density, against chopping down trees, for the preservation of heritage

buildings and for lower buildings etc. But many who are voicing these opinions have not fully realized the impact of low space standards in homes, work space and schools. I believe a balance should be struck between the need to preserve and the need for space.

The next 10 years - price growth to halve

With a pro-supply government and hence likely rising supply, and more proactive policies against price rises, we expect residential price growth to halve at best. If residential prices had grown at 5.2% each year between 2000 and 2010, we expect the best growth rate will be 2.6% annually between 2010 and 2020.

The next 12 months

With the Europe crisis relieved by LTRO in February and improving liquidity at local banks which caused mortgage rates to decline, inflationary fears have been restoked and this has debased the property market scene, with residential prices rising 4% YTD instead of falling. We believe higher demand from the need to hedge against inflation will persist for a few more months, and expect full-year residential prices to rise 8%.

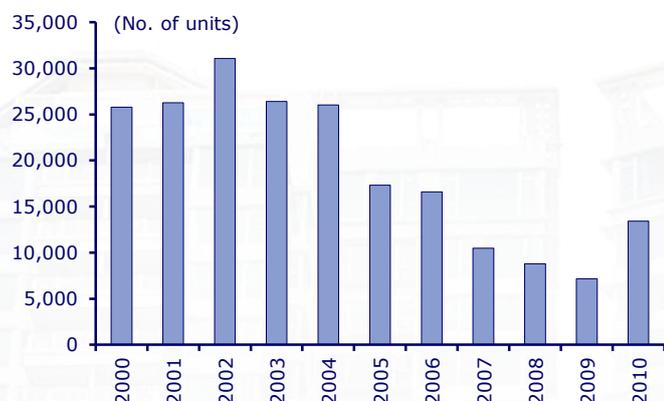
Some 21,897 units will be presaleable in 2012. This number is 19% above the average annual presaleable supply between 2006 and 2011. Our 2012 price assumption therefore implies demand in 2012 will rise by 27% YoY: sufficiently bullish in our view.

We derive our 2013 residential price assumption of a 1.5% increase from two scenarios: a 50% possibility that demand continues to rise by close to 20% YoY as interest-rate expectations remain tame - though as supply will be rising (we reckon by at least 10% YoY), prices will go up by only 8%; a 50% possibility that either an interest rate hike expectation or an economic growth scare kicks in, and demand declines, and prices fall marginally by 5%.

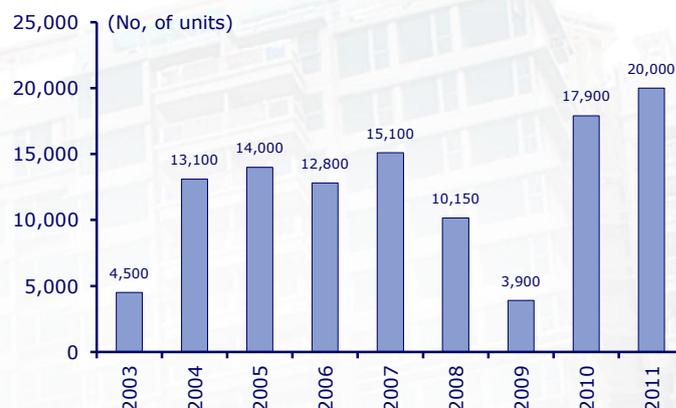
Our 2014 residential price assumption of a 5% correction assumes either an interest-hike expectation or an economic growth scare. Our 2015 residential price assumption of a flat prices assumes a recovery.

We expect office rents to decline 15% in 2012 due to the slowdown in the financial industry. We raised our office-rental forecasts from a previous 25% decline as equity markets stabilised after the LTRO.

We expect retail rents to grow steadily by 5-10% annually up to 2015, with no significant new supply and rising demand from increasing Chinese shoppers.

New completions


Source: Rates & Valuation Department, CLSA Asia-Pacific Markets

Land supply


Source: HK Government

Remarkable property-price growth

	CCI (index)	Resi rent (HK\$/sf)	Prime retail price (HK\$/sf)	Prime retail rent (HK\$/sf)	Grd A office price (HK\$/sf)	Grd A office rent (HK\$/sf)
2000	49.0	14.2	8,815	56.3	7,361	55.4
2010	81.2	18.7	22,500	97.7	17,623	97.6
2000-2010 growth (%)	66	32	155	73	131	76

Source: CEIC, JLL, CLSA Asia-Pacific Markets

Economic context

	Median household income (HK\$/mth)	No. of households earning >HK\$40k/m by end of year	HK retail sales (HK\$m pa)	HK stock mkt cap (HK\$bn)	HK stock mkt daily turn (HK\$m/day)
2000	17,450	332,000	186,699	4,711	12,340
2010	18,075	449,700	324,968	18,412	68,597
2000-2010 growth (%)	3.6	36	74	291	456

Source: CLSA Asia-Pacific Markets

Residential completions

	No. of units
2000	25,790
2010	13,405
Growth (%)	(48)

Source: Company annual report, CLSA Asia-Pacific Markets

All-in returns and drivers

2000-10	CKH	SHKP	HLD	NWD	Sino	HLP	Wharf	HKL	Hysan	GE	Tracker
Holding period all-in return (%)	33	109	74	93	404	510	257	301	232	168	68
- Abs shr-price return (%)	9	75	42	56	324	420	199	232	171	76	35
- Dividend return (%)	24	35	32	37	80	90	58	69	60	92	33
Compound annual return (%) ¹	2.9	7.7	5.7	6.8	17.6	19.8	13.6	14.9	12.7	10.4	5.4
U/L net profit growth	3	101	(14)	2,729	157	448	153	128	106	115	na
Revenue growth	252	29	47	47	272	443	61	247	19	62	na
2000 avg NAV (loc curr)	124	76	44	17	8	10	31	3	18	22	na
2010 avg NAV (loc curr)	130	140	74	25	19	33	66	7	43	38	na
2000 avg NAV disc (%)	24	13	19	39	54	39	50	33	48	45	na
2010 avg NAV disc (%)	22	17	31	44	22	3	32	17	42	43	na

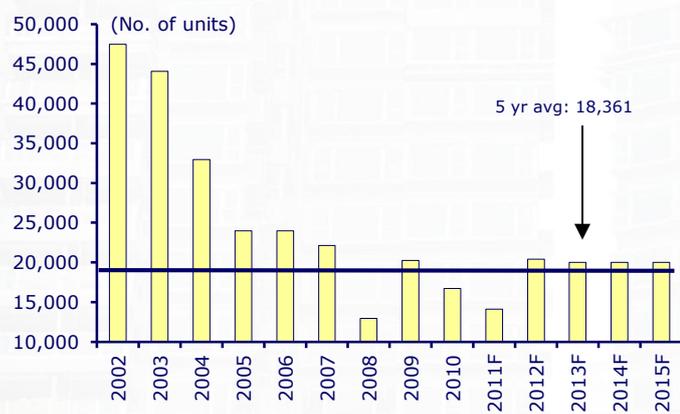
¹ Return on share price plus dividend. Source: CLSA Asia-Pacific Markets

Land supply (in more detail with breakdown by source of supply)

By calendar year, in No. of units	Application list	Land lease revision/exchange	URA	MTRC	Private redevelopment	Total land sold (in units)	Completion (in units)
2003	-	2,200	600	1,600	100	4,500	26,400
2004	5,400	5,700	1,600	-	400	13,100	26,000
2005	2,200	5,600	900	4,600	700	14,000	17,300
2006	1,800	800	300	8,900	1,000	12,800	16,600
2007	6,600	4,400	300	2,700	1,100	15,100	10,500
2008	50	3,300	1,200	4,700	900	10,150	8,800
2009	1,500	500	300	-	1,600	3,900	7,200
2010	5,800	7,300	1,600	1,200	2,000	17,900	13,400
2011F	na	na	na	na	na	20,000	na

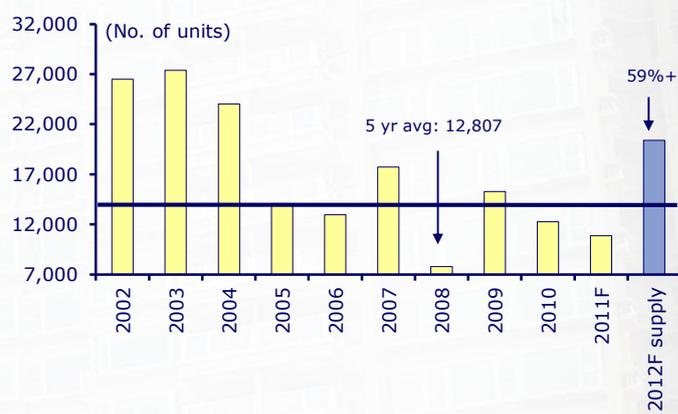
Source: CLSA Asia-Pacific Markets

Residential units available for sale



Source: CLSA Asia-Pacific Markets

Residential units sold



Source: Midland, CLSA Asia-Pacific Markets

Sector key assumptions - Quick summary

Sector key assumptions	2011	12CL	13CL	14CL	15CL
HK residential					
Price chg (% , YoY)	7.6	8	1.5	(5)	0
HK Central office					
CV (% , YoY)	20	(23)	5	10	10
Rent (% , YoY)	9.7	(15)	5	10	10
Cap rate (%)	4.75	5.25	5.25	5.25	5.25
HK non-Central office					
CV (% , YoY)	18	(20)	(5)	0	10
Rent (% , YoY)	23	(10) to (15)	(5)	0	10
Cap rate (%)	5.25	5.75	5.75	5.75	5.75
HK retail prime					
CV (% , YoY)	12	0 to (4)	12	10	10
Rent (% , YoY)	19	5 to 10	5 to 10	5 to 10	5 to 10
Cap rate (%)	5.25	5.75	5.50	5.50	5.50
China residential					
CV (% , YoY)	(10) to (15)	0.0	5 to 8	5 to 8	5 to 8
Volume (% , YoY)	11	10	2	2	2

Source: CLSA Asia-Pacific Markets

NAV growth and discount

	SHKP	HLD	Sino	NWD	Kerry	HLP	Wharf	HKL	Hysan	GE
Valuation										
Five-year avg disc to NAV (%)	16.6	28.1	20.8	38.8	27.6	17.0	36.4	23.1	42.4	44.2
1 SD in disc to NAV (pp)	16.5	16.5	18.2	16.8	22.5	16.3	13.8	13.2	9.6	11.5
End-FY12 NAV (loc curr) ¹	178.8	73.6	20.5	17.8	61.6	37.6	83.4	8.55	49.6	45.6
End-FY15 NAV (loc curr) ¹	196.2	77.4	23.3	18.2	70.9	45.3	109.6	10.35	58.7	53.9
Growth										
Hist five-year avg NAV Cagr (%)	10.3	7.5	12.4	(0.3)	17.4	13.3	11.0	12.7	7.2	3.1
2012-2015 NAV Cagr (%)	3.2	2.0	3.5	0.8	5.8	10.2	9.3	6.7	5.8	5.8

¹ All local currencies are HK\$, except for HKLand (US\$). Source: CLSA Asia-Pacific Markets

Earnings revision and growth

	SHKP	HLD	Sino	NWD	Kerry	HLP	Wharf	HKL	Hysan	GE
Earnings										
FY12 U/L net profit (loc curr m) ²	19,117	6,079	5,271	6,321	6,991	3,037	9,982	682	1,381	1,485
FY13 U/L net profit (loc curr m) ²	18,596	5,761	7,683	6,687	4,510	5,904	11,830	845	1,738	1,590
FY14 U/L net profit (loc curr m) ²	21,570	6,037	7,014	6,812	3,404	7,277	13,028	750	1,853	1,693
FY17 U/L net profit (loc curr m) ²	23,791	6,223	6,214	6,487	5,016	7,130	19,718	779	2,279	1,983
2012-2017 net profit Cagr (%)	2.1	1.1	3.3	0.5	(6)	18.6 ¹	14.7	2.7	10.5	6.0
2000-2010 net profit Cagr (%)	7.2	(1.4)	9.9	39.7	16.7	18.5	9.7	8.6	7.5	8.0

¹ The 19% Cagr includes choppy residential sales. Excluding this portion, the Cagr from recurrent income would be at 10%.

² All local currencies are HK\$m, except for HKLand (US\$m). Source: CLSA Asia-Pacific Markets

Rec, TP and valuation reference

	SHKP	HLD	Sino	NWD	Kerry	HLP	Wharf	HKL	Hysan	GE	MidL
Rec & TP											
Rec	U-PF	U-PF	U-PF	SELL	U-PF	O-PF	BUY	O-PF	SELL	U-PF	SELL
TP (loc curr) ¹	100	46.0	14.3	8.90	36.4	32.0	53.4	7.0	31	23	3.8
Five-year historic average											
Disc to NAV (%)	17.6	28.1	20.8	38.8	28	17	36	23	42	44	na
Dividend yield (%)	3.0	2.4	3.5	3.1	2.3	2.4	2.8	3.5	3.3	3.1	9.5
PB (x)	1.20	0.81	1.21	0.76	1.17	1.56	0.88	0.74	0.67	0.53	2.69
One-year forward PE (x)	18.0	18.3	18.8	12.5	18.6	27.8	14.9	18.6	20.9	11.5	11.2
Five-year volatility (1 SD for below metrics)											
Disc to NAV (pp)	16.5	16.7	20.3	17.14	22.18	16.3	13.7	13.0	9.6	12.0	na
Dividend yield (%)	0.8	0.8	1.2	1.1	0.8	0.8	1.1	1.4	0.9	1.2	8.4
PB (x)	0.32	0.25	0.48	0.3	0.46	0.40	0.22	0.18	0.14	0.15	1.03
One-year forward PE (x)	4.3	4.9	7.7	6.6	4.9	4.6	6.6	7.7	5.8	7.4	37
Trough valuation (GFC)											
Disc to NAV (%)	44.2	61.2	77.1	75.4	65.8	56.6	77.3	52.1	67.9	79.2	na
Dividend yield											
PB (x)	0.59	0.40	0.32	0.26	0.37	0.81	0.34	0.34	0.34	0.22	0.27
One-year forward PE (x)	9.1	9.3	4.00	4.59	5.6	11.8	5.7	5.27	11.1	4.1	na

¹ All local currencies are HK\$, except for HKLand (US\$). Source: CLSA Asia-Pacific Markets

CLSA Viewpoint

Energy: The politics of power



Rajesh Panjwani
Head of Power
Research

The imminent tariff hike for customers in Kowloon and the New Territories makes Hong Kong's utilities vulnerable to policy risk. The key trigger is the 40% tariff hike that CLP needs to implement to pass on (as per its 2011 annual report) higher fuels costs. Given the end-2011 experience, we think these tariff hikes are unlikely to go through.

The possible solutions are: 1) tariff hikes are spread over a longer time period - which will hit CLP's cashflow but should not have a big impact on earnings; 2) government subsidises power tariffs to minimise the impact on customers; and 3) a combination of the two options. Apart from potential pressure on cashflow, this issue is also likely to result in a cut in the 10% return on assets power utilities are allowed to earn (higher than the c.7% UK utilities are allowed with similar capital costs) after the current Scheme of Control expires, and will also lead to closer scrutiny of costs and capex. Power Assets is less affected because it does not face near-term cost pressures like CLP. We have Underperform ratings on CLP and PAH and a SELL on CKI.

Sharp increase in fuel costs means big tariff hike . . .

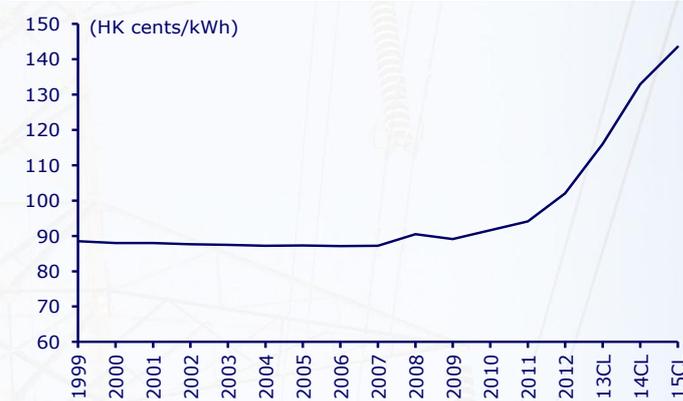
CLP was earlier buying gas at c.US\$5-6/mmbtu from the South China Sea. This well is at the end of its life and the price of pipeline gas from China is likely to be 2.5-3x higher. CLP also needs to raise the share of (costly) natural gas in its generation from the current

23% to over 35% by 2015 to meet the HK government's environmental targets for SO₂, NO_x and RSP emissions. The resulting increase in fuel costs will require a 40% tariff hike.

. . . but resistance to these tariff hikes is strong

This is a big departure from the past - over the past 15 years, the average annual increase in power tariffs in Kowloon and the New Territories has been only 1.1%. In 2012, CLP initially proposed a 9.3% tariff hike, which it cut to 4.9% after public protests and government pressure. The rise needed for the next two to three years is likely to be higher than what was required for 2012. Given the fate of the 2012 hikes, it seems unlikely CLP will be allowed to get double-digit tariff hikes for the next few years.

CLP's electricity tariff



Source: CLP, CLSA Asia-Pacific Markets

Emission targets for CLP's and PAH's HK electricity business: 2015

Tonnes per year	Sulphur dioxide	Nitrogen oxides	Respirable suspended particulates
Lamma Power Station (mixed fuel)	6,780	10,020	300
Hongkong Electric	6,780	10,020	300
Change from 2010 allowed level (%)	(28)	(37)	(36)
Black Point Power Station (gas-fired)	1,440	4,140	110
Castle Peak Power Station (coal-fired)	4,260	13,390	420
Penny's Bay Gas Turbine Power Station (oil -fired)	2	2	1
CLP Power Hong Kong	5,702	17,532	531
Change from 2010 allowed level (%)	(64)	(34)	(33)
Total	12,482	27,552	831
Change from 2010 allowed level (%)	(50)	(35)	(34)

Source: CLSA Asia-Pacific Markets

CLP's tariffs for 2012 - Initial proposal and subsequent changes

HK cents/kWh	2011	2012 first proposal	% change	2012 second proposal	% change	2012 final proposal	% change
Average basic tariff	80	85	6.3	85	6.3	84.2	5.3
Fuel-clause surcharge	14.1	17.8	26.2	16.1	14.2	17.8	26.2
Rents and rates special rebates	0	0		0		(3.3)	
Total	94.1	102.8	9.2	101.1	7.4	98.7	4.9

Source: CLP, CLSA Asia-Pacific Markets

Excerpts from CLP’s 2011 annual report

From the chairman’s statement:

Government’s choice leads to more gas-fired generation and has already required the investment of about HK\$9 billion in further emissions reduction plant for coal-fired generation at Castle Peak. **These environmental improvements must be paid for.** Let me take the increased use of gas as an example. The cost of fuel used to generate electricity for our Hong Kong customers is passed through to customers under CLP’s fuel clause charge. CLP and its shareholders make no profit on fuel. At present, the amount charged under the fuel clause is set at a level which recovers only the costs of coal purchases and the cheap Yacheng gas (contracted for 20 years ago, and with declining production due to field depletion). **In fact, over the past five years, the amounts charged to customers have not even been sufficient to cover the lower, historic fuel costs. By the end of 2012, unless the cost of fuel is more fully borne by those customers who benefit from the electricity which it generates, CLP’s customers would have paid about HK\$800 million less than the actual costs of the fuel used to supply their electricity in the past.**

As a result of the gas supply agreements with Mainland suppliers, required by the MOU signed by the SAR Government, we estimate that, **by 2015, fuel costs alone will increase by around 250% from current levels. This is the equivalent of about a 40% increase in overall cost to the consumer and will require regular and substantial tariff increases over the intervening period.** I emphasise, once again, that this increase represents the price of gas paid to Mainland suppliers - none of this increase is for the benefit of CLP’s shareholders.

From the CEO’s statement:

Although our environmental performance has been first-rate, we expect to lower our emissions even further, including carbon emissions. **This will involve further investments in lower carbon emission generation and, over time, a continued move away from coal-fired generation - provided that Government and our customers understand the implications of doing so on tariff levels, reliability and energy security.**

Near-term risk to CLP’s cashflows . . .

The most immediate question is whether CLP will be able to raise tariffs by 40% by 2015. On the 2012 experience, this looks very difficult. One option is that CLP spreads the cost increase over five to seven years instead of three. This would lead to an under-recovery of costs and returns in the next few years but an over-

recovery later on. This option may not affect reported earnings but will hit CLP’s cashflow over the next few years. Under this scenario, unless CLP lists its Australian business or takes on more debt, its ability to pay dividends may be reduced to some extent.

The other option is that government takes a large part of the burden of tariff hikes by subsidising consumers, so that the net tariff hike is in the mid-single digits. The third option is a combination of these two scenarios, where the government bears a part of the burden and CLP the rest in the form of lower cashflow in the near term but an over-recovery in the longer run.

Power Assets is much better positioned on this front. It does not face a sharp increase in gas costs as one of its gas contracts runs until 2029 (signed in 2004) while another 2008 agreement sees it paying the market price for gas. Moreover, Power Assets does not need to raise the share of gas in its power generation to meet the 2015 emissions targets. Thus its required tariff hikes are much lower than CLP’s. As is evident from the chart below, Power Assets has already raised tariffs much more than CLP: a 2.8% average compared to 1.1% for CLP over the past 15 years.

. . . longer-term risk to returns

This unprecedented hike has brought the focus back on the returns earned by HK utilities and the level of capex they are allowed to undertake. The most recent Scheme of Control agreement in 2008 cut the return on assets earned by Hong Kong’s power utilities from c.14% to c.10% in 2008. However, even this 10% is high compared to returns prevalent in the UK, which has similar interest rates to Hong Kong. The comparison with UK is becoming more stark given that Power Assets bought UK Power Networks last year, which earns a 4% real rate of return. Given 3.1% average inflation over the past ten years, this translates into a 7.1% nominal return - c.3ppt lower than those earned by HK utilities, though both regions have similar interest rates.

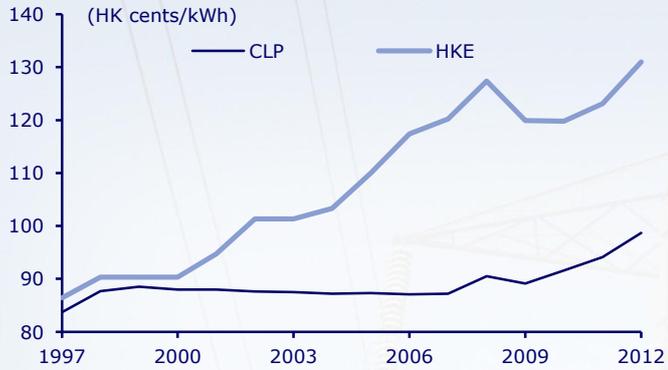
CLP most exposed to HK electricity; CKI least

CLP is the most exposed to the risk of returns being cut in Hong Kong as it faces the steepest fuel-cost inflation in the coming years. It also derives c.70% of its profits from Hong Kong compared to 46% for Power Assets and 21% for CKI.

Allowed return on assets (%)	Real	Nominal
Hong Kong		
CLP	-	9.99
PAH	-	9.99
PAH/CKI’s UK businesses		
UK Power Networks	4.0	7.1 ¹
Northern Gas Networks	4.3	7.4 ¹

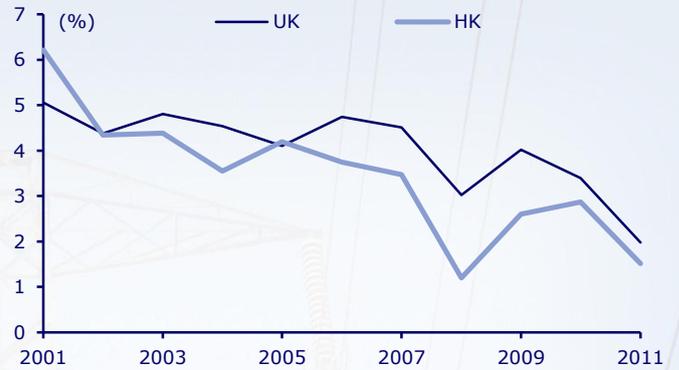
¹ Nominal return is calculated as a sum of allowed real return and UK’s 10-year average inflation (RPI) of 3.1%. Source: Companies, Ofgem, Ofwat

CLP and PAH electricity tariffs over past 15 years



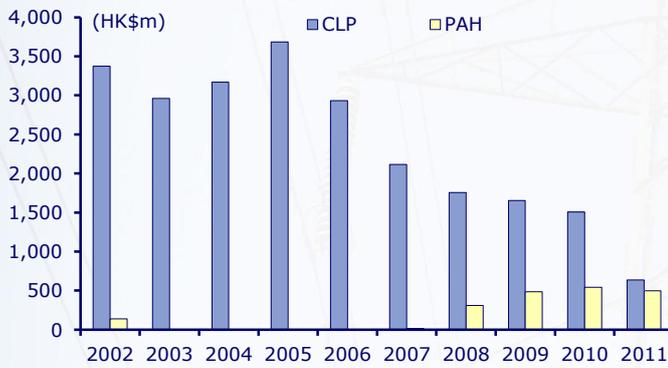
Source: CLP, CLSA Asia-Pacific Markets

Yields on 10-year government bonds



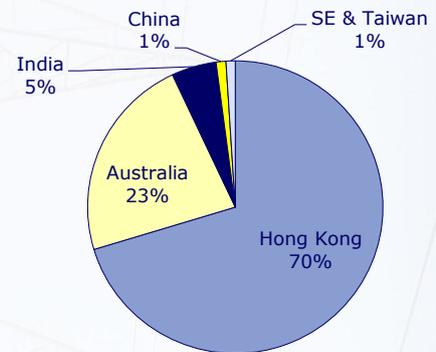
Source: Bloomberg, CLSA Asia-Pacific Markets

Tariff stabilisation funds of CLP and PAH



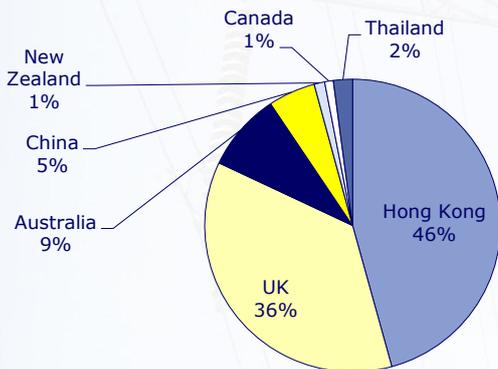
Source: CLP, PAH

CLP's 2011 operating profit before unallocated items



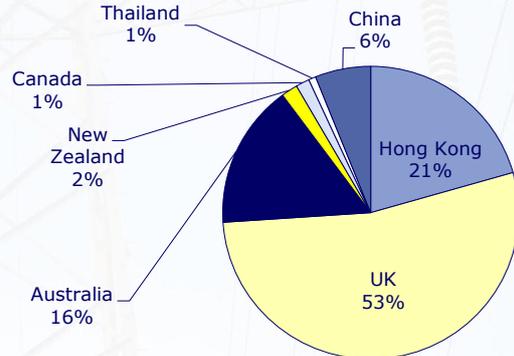
Source: CLP, CLSA Asia-Pacific Markets

PAH's 2011 PAT before unallocated items



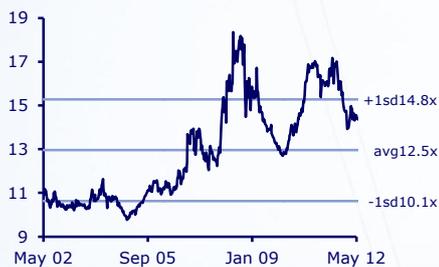
Source: PAH CLSA Asia-Pacific Markets

CKI's 2011 PAT before unallocated items



Source: CKI, CLSA Asia-Pacific Markets

CLP PE ratio



Source: CLSA Asia-Pacific Markets

Power assets - PE ratio



CKI - PE ratio



CLSA Viewpoint

Sustainables: Few clues



Charles Yonts
Head of Sustainable Research

Environmental issues are a major part of one of the five planks of CY Leung’s manifesto. There is a self-evident need to address Hong Kong’s poor air quality, Hong Kong has a clear waste-disposal problem, and there is a debate raging about a proposed incinerator. Water also came to prominence during southern China’s droughts and pollution scandals last year. Hong Kong relies on Guangdong for about 70% of its water.

While environmental policies are clearly important for maintaining Hong Kong’s competitiveness, Leung’s published statements on the topic do not point toward too many clear, major implications for equity investors. The three areas we will watch most closely are emissions targets for electricity generation, municipal solid waste and fresh water sourcing and conservation.

Air pollution

HR-consultancy ECA International cited air pollution as Hong Kong’s Achilles heel in its latest poll of the world’s most liveable cities for expats. Hong Kong slipped out of the top 10, while Singapore came top. And while this study focuses on expats, complaints about the environment and pollution are clearly not limited to foreigners. It even risks falling behind some mainland cities as they tighten reporting and emission standards.

According to the Environmental Protection Department (EPD’s) data, electricity generation is Hong Kong’s biggest source of air pollution at 88% of SO₂, 44% of nitrogen oxide (NOx) and 28% of particulate matter (respirable suspended particulates - RSP). Emissions targets naturally focus on the power sector as well.

The government’s 2020 targets (details in Section 3) necessitate a shift from coal to pricier gas and offshore wind, which will mean challenges for the big genco’s as they try to pass on costs. Our power head, Rajesh Panjwani, looks at this in more detail in the following pages. To hit these targets, Hong Kong will also have to buy more nuclear power from over the border, which is sure to elicit some public pushback post-Fukushima.

Solid waste

Like much of China, Hong Kong intends to follow in Europe and Japan’s footsteps in waste processing by building a (big) 3k-tonne waste incinerator off Lantau. Even with landfills filling up, there is still heavy opposition to the proposal to spend HK\$23bn for extensions and for the new incinerator. The EPD has echoed green groups in highlighting the need for more recycling and waste-charging fees, in line with regional cities like Seoul and Taipei.

Ultimately, the incinerator seems inevitable and is one of the more pressing issues CY Leung faces. As we have argued previously, most (but not all) environmental concerns about waste incineration have been addressed with newer emission-control designs. Using cutting-edge equipment, leading operators like China Everbright Intl have achieved great success across China, even as dozens of towns and villages nationwide protest new incinerators. Everbright also produces moving-grate incinerators, the technology Hong Kong is most likely to use. Given that it is still a relatively new manufacturer, the company is highly unlikely to beat out established European brands for the project. We have a BUY rating on the stock.

Water

Hong Kong relies on Dongshan (Guangdong) for around 70% of its fresh water. The water-sharing agreement dates back to 1960 and it is due to be renewed in 2014. While there is very little chance of Hong Kong being cut off from its Guangdong water supply, there is a very real risk that the contract cost will rise substantially as urban centres over the border angle for more water. Historically, the economic benefits to Guangdong of selling to Hong Kong have been far too large and obvious for this risk to really develop. That is changing.

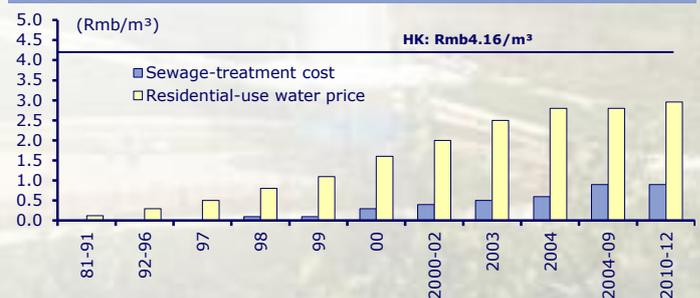
Hong Kong’s water tariff, at US\$0.64/m³, is double Guangzhou’s (US\$0.32/m³), but less than half Singapore’s (US\$1.52/m³) and less than a quarter New York’s US\$2.7/m³. Most importantly, the gap between Hong Kong and its mainland neighbours has been shrinking. The chart below shows how Beijing has been closing the gap with Hong Kong’s water tariffs.

Emission targets for CLP and PAH in Hong Kong: 2015

Tonnes per year	SO ₂	NOx	RSPs
Lamma Power Station (mixed fuel)	6,780	10,020	300
Hongkong Electric	6,780	10,020	300
Change from 2010 allowed level (%)	(28)	(37)	(36)
Black Point Power Station (gas-fired)	1,440	4,140	110
Castle Peak Power Station (coal-fired)	4,260	13,390	420
Penny’s Bay Gas Turbine Power Station (oil -fired)	2	2	1
CLP Power Hong Kong	5,702	17,532	531
Change from 2010 allowed level (%)	(64)	(34)	(33)
Total	12,482	27,552	831
Change from 2010 allowed level (%)	(50)	(35)	(34)

Source: Legco, CLSA Asia-Pacific Markets

Beijing water tariffs: Catching up



Source: Municipal government

CLSA Viewpoint

Retail: Duopolis



Jonathan Galligan

Suppressed land supply and high property prices have created a difficult environment for supermarket operators trying to enter the market, particularly when Hong Kong's two heavyweights - Hutchison Whampoa and Jardines - refuse to let go of their prime locations and nearly 75% market share. Competition between the two has at times been fierce, with price wars and low-single-digit Ebit margins, but it has also squeezed out competitors - and will continue to do so - as the competition will struggle to replicate their scale or move into prime locations.

Marketshare hold

Over the past 40 years, Jardines - through Dairy Farm and its flagship Wellcome brand - and Hutchison - through Park n Shop - have controlled the Hong Kong supermarket space. While both Dairy Farm and Hutchison trace their roots in Hong Kong's consumer market back over a century, Dairy Farm acquired Wellcome in 1964 and Hutchison bought Park n Shop in 1972, giving them a unique first-mover advantage which is the foundation of their current positions.

Today, Hutchison and Dairy Farm control almost three quarters of the Hong Kong supermarket and grocery market and have done little to cede their stakes over the past decade.

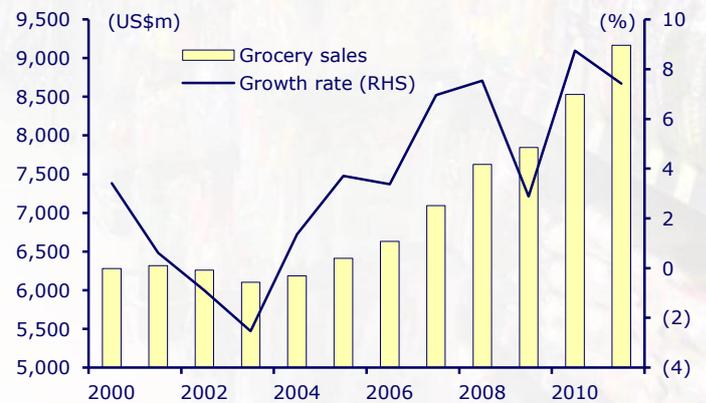
Their dominance is so strong that the deep-pocketed French hypermarket chain Carrefour was forced to exit Hong Kong in 2000, after opening just four stores in four years. In September of that year, it announced that it was shutting its four Hong Kong stores 'due to its difficulties in finding large sites suitable for developing

its hypermarket concept'. There were also reports that the group racked up substantial losses as it struggled to develop cost-competitive procurement, rental prices remained high and Hutchison and Dairy Farm engaged in a price war which eroded margins for other players as well.

With just 1,104km² of land in Hong Kong and sky-high property prices, finding viable locations remains the biggest barrier to new entrants trying to expand into the market and continues to be the most significant hindrance to scaling up the business. The plight of Carrefour illustrates the difficulties that Hong Kong represents as a market and the uncompetitive operating environment that has been created by its two dominant players.

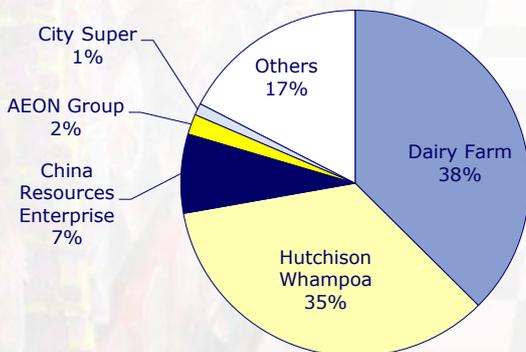
While the Hong Kong market contracted from 2000 to 2004, the last several years have seen increasing growth, which only continues to benefit Jardines and Hutchison.

Hong Kong grocery sales



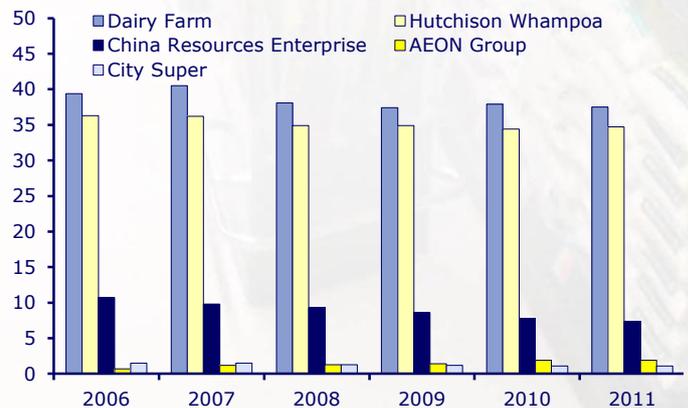
Source: CLSA Asia-Pacific Markets, Euromonitor

Market share of Hong Kong's supermarkets, 2011



Source: CLSA Asia-Pacific Markets, Euromonitor

Market share of Hong Kong's supermarkets



Endnotes

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- ⁵ Full information of who stood for selection, the number of votes and who were selected are available from the Electoral Affairs Commission website, <http://www.eac.gov.hk>.
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- ⁸ Phila Siu, "Tang's support still growing", 23 February 2012.
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- ²⁰ The Financial Times article wrote: "In his first interview with foreign media since his victory, Mr Leung said Hong Kong must pull away from a "small government, big market" model, and that he would address imbalances in the economy and make companies "pay for their costs to the community". Though details remain scarce, proposals include providing more subsidized housing", see Enid Tsui and Henny Sender, "Hong Kong: a majority to accommodate", *Financial Times*, 19 April 2012. The chief executive-elect's office issued a press release to clarify "a misquote". The press release said that: "The CE-elect has not made such a remark, neither was such a proposal included in his manifesto. What the CE-elect said was: "As far as housing is concerned, my proposal is to fill in the gap (between property prices and what people can afford) by providing subsidized housing, including public rental units and Home Ownership Scheme units", Government Press Release, "Chief Executive-elect's office clarified misquote in FT article", 20 April 2012.
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