

Sun Hung Kai - Falling from Grace

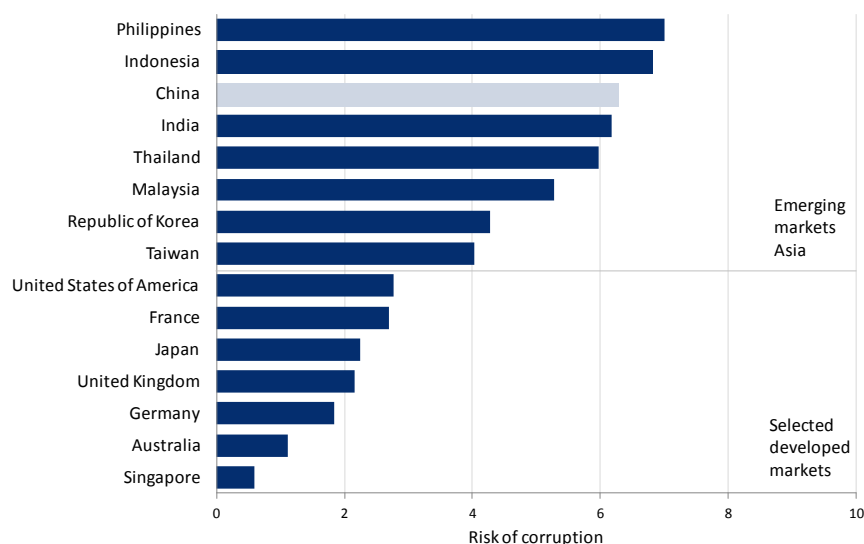
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The arrest of eight individuals related to Sun Hung Kai Properties Limited (SHK), including co-chairmen Raymond and Thomas Kwok, by Hong Kong's *Independent Commission Against Corruption* (ICAC) has led to widespread concern over the company's outlook. Investors reacted badly to the news, with a steep fall of over 15% in the company's share price on the morning of 30 March 2012, wiping approximately USD 5 billion off SHK's market capitalization, marking a "Black Friday" in the company's history.

MSCI ESG Research flagged concerns over the company's governance practices prior to the allegations. We classify the company's operations in Hong Kong and mainland China as facing high exposure to corruption risks and assessed SHK as having inadequate anti-corruption programs in place to mitigate those risks. Figure 1 below illustrates the likelihood of corrupt acts in selected countries scaled in a range from 0 to 10, with 10 being the highest risk based on our analysis of independent data from *Transparency International*¹. China, including Hong Kong and Macau, has high corruption risks compared to most developed market countries and compared to most of emerging markets Asia.

Figure 1: Exposure to bribery and corruption risks



Source: Transparency International

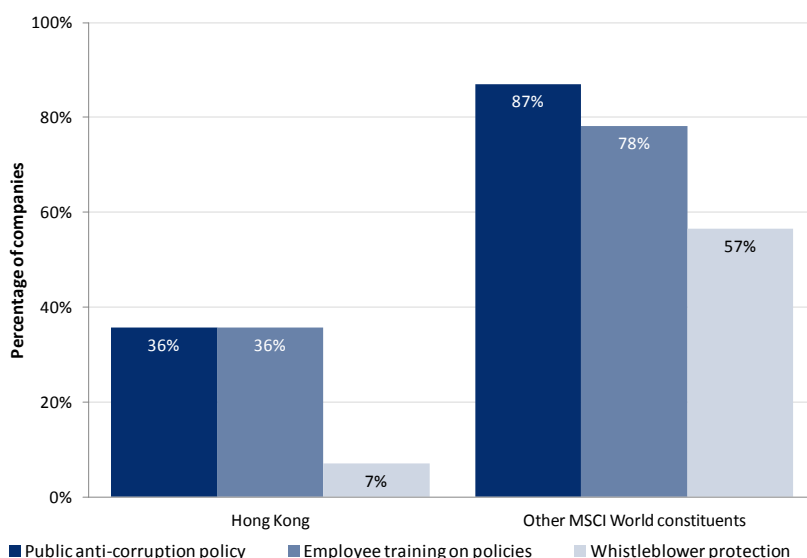
In our 2011 review, we rated Sun Hung Kai in the bottom quartile for the corruption and instability key issue against global 'Real Estate Management and Development' peers. **We found no evidence to suggest that the company had implemented group-wide anti-corruption policies, or related programs such as whistleblower protection and employee training related to corruption, or structures such as independent audits covering the relevant ethical standards.**

¹ See IVA Methodology Document for more details on our assessment of risk exposure to corruption.

Given its high risk exposure and the limited scope of its governance policies, we assessed the company to be more susceptible to incidents of bribery and corruption than most of its industry peers. The new allegations provide further confirmation of the company's weaknesses in internal controls.² We believe that legal proceedings, reputational damage that increase difficulties in gaining future regulatory approvals, and loss of investor confidence in management could have a prolonged impact on the company's outlook.

Meanwhile, other Hong Kong developers have been affected negatively by SHK's news, with Wharf Holdings Ltd. off by 2.2%, Henderson Land Development Co. down 4.1%, and Sino Land Co. losing 4.5% in Friday trade. In our 2011 review of global 'Real Estate Managers and Developers', **we identified that the Hong Kong and mainland China subset trailed its global peers in anti-corruption measures while being exposed to high legal and reputational risks associated with this issue.** Figure 2 illustrates some of the differences in disclosed anti-corruption programs between 'Real Estate Managers and Developers' in Hong Kong and other countries represented in the MSCI World Index.

Figure 2: Anti-corruption programs - Real Estate Management & Development industry



While the real estate development industry has a reputation for being prone to corruption, we expect intensified political will and regulatory efforts in China and Hong Kong to reshape this aspect of the industry landscape. China has been making unprecedented moves to take the anti-bribery battle global by co-operating with foreign law enforcement agencies and international watchdogs. Disparity in income distribution and public anger over perceived collusion between business tycoons and government officials in Hong Kong are also two emerging drivers of sustained changes in corporate behaviors.

As the central and local governments in China escalate their crackdown against corruption, companies that rely on illegal use of "guan xi" ("relationship" or "network" in Chinese) in land acquisition, winning

² Sun Hung Kai's overall MSCI ESG IVA rating was downgraded from 'B' to a 'CCC,' as a result of a mid-cycle review of the company, triggered by the arrests on March 29, 2012.

contracts, and passing other approval processes, will in turn face higher risks of fines associated with violations, regulatory intervention, potential brand damage and possible loss of competitive advantage in the market. This latest investigation over Sun Hung Kai's business dealings, possibly the most high profile corruption case since the launch of ICAC, is evidence of this trend.

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