9900-048 Hong Kong Disneyland

For discussion **FCR(1999-2000)48**
on 26 November 1999

ITEM FOR FINANCE COMMITTEE

CAPITAL INVESTMENT FUND
NEW HEAD "TOURISM"
New Subhead "Equity in Hongkong International Theme Parks Limited"
New Subhead "Loan to Hongkong International Theme Parks Limited"
New Subhead "Subordinated Equity in Hongkong International Theme Parks Limited"

Members are invited to approve a commitment to inject $3,250 million as equity, to provide $5,619 million as a loan from the Capital Investment Fund to Hongkong International Theme Parks Limited and to approve an investment of $4,000 million in subordinated equity by the Capital Investment Fund representing land premium for the Phase I site to allow the company to proceed with the development and operation of Hong Kong Disneyland.

PROBLEM

The Government has reached agreement with The Walt Disney Company (WD), subject to the approval of the Executive Council, the Legislative Council and the WD Board, to develop a world class international theme park which will operate under the name of Hong Kong Disneyland (HKD). The commercial terms of the agreement provide for the Government to participate as an equity investor in the company which will develop and operate HKD, Hongkong International Theme Parks Limited (HKITP), to provide a loan to HKITP and to invest $4 billion by way of land premium cost as subordinated equity in HKITP.

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PROPOSAL

2. The Commissioner for Tourism, with the support of the Secretary for Economic Services, recommends that Members approve a commitment of $3,250 million as equity and $5,619 million as loan from the Capital Investment Fund, and an investment of $4,000 million in subordinated equity by the Capital Investment Fund representing land premium for the Phase I site.

JUSTIFICATION

Background

3. WD has been exploring the possibility of developing a theme park in Hong Kong and has been searching for some time for a site that could meet its requirements. Meanwhile, the Government has been preparing possible alternative development scenarios for Northeast Lantau and has concluded that it would be better to switch the planning intention from the originally intended port development land uses to recreation and tourism-led ones. In late 1998, both parties came to the view that Penny's Bay at Northeast Lantau would make an appropriate location for a Disney theme park if agreement could be reached on financial and other terms.

4. Recognising the substantial economic contribution that a Disney theme park could bring to Hong Kong, Government started formal negotiations with WD in February 1999. At an early stage, the two parties discussed the possibility of bringing in third party investors from the outset. However, in view of the scale and complexity of the project and the need for close liaison during the development stage, we came to the conclusion that a Government-Disney partnership was the best way forward. On 31 October 1999, the two parties reached agreement on the development of a Disney theme park at Penny's Bay on Lantau Island. We briefed the House Committee and the Economic Services Panel of the Legislative Council on the key aspects of our agreement with WD a number of times during the past few weeks.

Financing

5. The estimated total project cost to HKITP of developing HKD Phase I is $14.1 billion (in money of the day prices). This is in addition to the cost of reclaiming the land for Phase I of the project, which is estimated at $4 billion (in money of the day prices). Therefore the commercial aspects of the negotiations centred around how to fund the $18.1 billion, the financial prospects of the proposed theme park, and the rates of return for WD and the Government.

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6. WD's forecast of the financial performance of HKD (the "Base Case") showed that the project could cover the cash cost of building and operating the theme park and related facilities, but could not cover the cost of the land. Given the very substantial economic and other benefits that HKD would bring to Hong Kong, the Government agreed not to demand cash up front for the land premium, subject to certain conditions, the main ones being -

(a) the full premium would be paid in subordinated shares which would convert to ordinary shares progressively during the life of the project to the extent that operating performance exceeded the Base Case. In this way the Government would capture its fair share of the project's upside potential;

(b) WD would agree to take a significant initial equity stake and retain most of it for the life of the project. In this way the Government would ensure the sustained commitment to the project; and

(c) the Government would hold a majority stake initially to protect its interest, but with the ability to sell down subsequently to third party investors.

7. In order to ensure that HKD will remain attractive as a commercial venture to existing and potential third party investors, the subordinated shares will need to be converted in a gradual manner. This will ensure that the benefits of the ordinary shares held by other investors will not be diluted substantially within a short period of time. Moreover, to allow for fluctuation in business in the early years of HKD, both sides also agreed that conversion will only begin after five years of theme park operation. The permitted conversion ceiling will thereafter rise by 5% per annum cumulatively thus rendering full conversion of the subordinated shares possible 25 years after opening. In order to prevent excessive equity dilution in any one year there is an annual cap of 10% on conversion.

8. The land premium for the Phase I site has been set at $4 billion, being the pro rata cost of that portion of the land reclamation and site formation taken up by the first phase of HKD (i.e. 126 hectares). This sum will be spent from the Capital Works Reserve Fund, but, as the shares issued by HKITP in payment will be credited to the Capital Investment Fund, we need approval for the investment.

9. The Government and WD agreed that the cost of constructing HKD, at $14.1 billion should be financed by a mixture of debt and equity at a commercially prudent ratio of approximately 60:40. This translates to $5.7 billion in equity and $8.4 billion in debt.

10. Initially WD will put up $2.45 billion in equity for one-dollar shares and hold a 43% stake in HKITP. It will later be allowed to sell down but not below the level of 1.9 billion shares. The Government will initially put up $3.25 billion in equity for one-dollar shares in HKITP and hold a 57% stake. The Government can sell down its stake to a minimum of one billion shares up to the end of the first year of operation. Thereafter, it can sell its shares (and also any subordinated shares that convert to ordinary shares - see paragraphs 6 and 7 above) without any requirement for a minimum holding.

11. The debt of $8.4 billion will be raised by a commercial loan of $2.3 billion and a Government loan of $6.1 billion, the latter repayable over 25 years from park opening. (Both loan figures include capitalised interest estimated at $0.7 billion.) The reason for raising just over a quarter of the debt from the open market is that in the early years the project cash flows can only prudently cover loan servicing of that amount. Repayment of the Government loan will begin ten years after HKD opens when the commercial loan has been paid off.

12. To help the project in its early years, the Government loan will carry interest on a sliding scale as follows -

Prime minus 1.75%	from drawdown to the first eight years after park opening
Prime minus 0.875%	for the next eight years
Prime	for the next nine years

13. Detailed terms of the Government's equity injection and the conversion of the subordinated shares are provided for in a Shareholders' Agreement between the Government and the wholly-owned WD subsidiary which will hold its shares in HKITP, while those of the Government loan are provided for in the Loan Agreement to be made between the same parties.

14. The following summarises the financing of the project.

Funding Sources	**Amount ($ billion)**	**% to Total**
Equity, of which	**5.7**	**40.4%**
- Government	3.25	23%
- Disney	2.45	17.4%
Debt, of which	**8.4**	**59.6%**
- Government	6.1*	43.3%
- Commercial	2.3*	16.3%
Total	***14.1***	***100%***

* Including capitalised interest.

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Evaluation

15. The success of the project lies in its ability to attract adequate patronage both from within and outside Hong Kong. We have examined the Base Case calculations with the help of our financial advisers and concluded they are a prudent estimate and therefore form a reasonable basis for proceeding with the project. The Base Case assumes an initial annual attendance of some five million gradually increasing to some ten million upon Phase I build-out. This compares with the annual attendance of the Disney theme parks around the world, which ranges from some eight million to 17 million. The Base Case also assumes a market penetration rate ranging from 19-23% for the local residents market and 24-25% for leisure visitors (including both existing and induced visitors). The increase in total theme park attendance from five million to ten million upon Phase I build-out, and the increase in overseas visitor attendance for the theme park over the same period, are not considered particularly ambitious given that it is spread over a period of some 15 years. According to the World Tourism Organisation, visitor arrivals to Hong Kong are forecast to increase substantially over the next 20 years.

16. In financial terms, we expect to achieve a reasonable return on our investment. The project's forecast internal rate of return compares favourably with those of other major infrastructure projects in which we have invested, such as the airport and railways, and, as noted above, the project has considerable upside potential.

Control Mechanism

17. As the largest shareholder in HKD, we need to safeguard Government's interest in this project. Apart from the various project agreements entered into, Government will have a majority on the Board of Directors of HKITP. Two non-executive independent Directors mutually agreed by both Government and WD will also be appointed to the Board. While the day-to-day operation of the theme park will be managed by the management company (a 100% WD-owned subsidiary), the Board will exercise a supervisory role.

FINANCIAL IMPLICATIONS

18. Subject to Members' approval, Government proposes to inject $3.25 billion in annual tranches pro rata with WD in accordance with the cashflow needs of HKITP.

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19. The forecast cash flow for loan drawdown and equity injection is as follows -

	Loan $ million	**Equity $ million**
1999-2000	-	145
2000-2001	624	120
2001-2002	403	329
2002-2003	1,373	794
2003-2004	2,779	1,607
2004-2005	440	254
Total	5,619	3,250

Tourism Commission
Economic Services Bureau
November 1999