

## Evergrande – House of cards

Rating: **SELL (-23%)**

Last close: **HKD 3.08**

Target Price: **HKD 2.50**

Evergrande is among China's largest property developers – ranking first by saleable area as it has historically relied on volume and low prices to expand aggressively. We note that short-seller Citron Research alleged Evergrande of fraud in 2012, but the claims were vigorously refuted and Evergrande went to record over 40% bottomline growth in FY13. However, as the China residential property market starts to slow down alongside the economy, exacerbated by tight credit and home ownership restrictions, we think Evergrande, as the largest and most indebted, will be most at risk. Additionally, questionable management decisions raise more red flags than a Communist parade:

- **Stunning cash outflows on negative FCF guidance.** An 18% HKD3bn dividend comprising 71% of earnings while guiding negative free cash flow for FY14; share repurchases totaling HKD3bn and purchase of a stake in Huaxia Bank for ~HKD1bn.
- **Veteran management selling shares and leaving the company.** CEO Xie Haijun sold 68m shares, his first sale since joining the Board in 2007; Li Gang, the vice-Chairman, resigned effective May 1 and sold 33m shares in April after a 8-year tenure; Lai Lixin resigned as Executive Director in February. In contrast, according to Evergrande's annual reports, there were no management changes in 2010-2013 during the previous property downcycle.
- **Cash outflow from operations far beyond peers as promotions lower cash collection.** In Qinhuangdao, in response to a price war with rival developer Vanke, Evergrande is offering to cover two-thirds of the required 30% downpayment until construction is completed in a year, in order to attract buyers. This and its large-scale developments has led to Evergrande reporting 331% the cash outflow from operations compared to its nearest peer Guangzhou R&F.
- **Ever-increasing debt levels and shadow bank borrowings.** Evergrande's reported debt increased by 80% YoY in FY13, bringing gearing to a reported 87%. However, when adjusted for perpetual securities accounted for as equity, we estimate Evergrande's gearing in excess of 185%. Additionally, management replied that they intend to add to their perpetual securities instead of refinancing them in FY14, at a much higher estimated financing cost of 10-15%. Lastly, in Jan 2014, Evergrande pushed through a consent solicitation of its 2015/16 bonds, amending the covenants with an increased basket for purchase money debt and additional categories of "Permitted Indebtedness".

Evergrande was downgraded by S&P to B+ April 2014, further impairing its ability to refinance. Crucially, a USD750m bond issue comes due in January 2015. Evergrande's estimated USD16bn of cash will not be nearly enough – although management claims it is. We value Evergrande at 2.7x FY15 consensus P/E (50% of peers).

### Financial Highlights

FY End: 31 Dec (RMB m)	FY11	FY12	FY13	FY14E	FY15E
Revenue	61,918	65,261	93,672	105,214	117,860
EBIT	15,513	11,859	18,753	21,845	24,322
Net profit	11,324	9,171	13,268	10,555	11,430
EPS	0.757	0.613	0.789	0.71	0.78
Revenue YoY %	35.2%	5.4%	43.5%	12.3%	25.8%
EBIT YoY %	14547%	50%	-24%	16%	30%
Net Profit extra YoY %	6,117	9,335	6,699	-	-
EPS YoY %	584%	50%	-19%	29%	-10%
EBIT Margin (%)	25.1%	18.2%	20.0%	20.8%	20.6%
Net Profit Margin (%)	18.3%	14.1%	14.2%	10.0%	9.7%
Net Gearing (%)	92.7	101.9	86.6	-	-
Total debt/common equity	161.8	157.5	224.0	-	-
P/E (x)	3.5	5.6	2.9	4.3	3.9
P/B (x)	1.2	1.3	0.8	-	-
EV/EBITDA	4.6	7.8	6.9	6.1	5.6
Dividend Yield (%)	7.3	0.0	18.6	-	-

Source: Bloomberg

Company Name: Evergrande  
Real Estate Group Ltd  
Bbg Ticker: 3333 HK

Last close: **HKD 3.08**

Target Price: **HKD 2.50 (-23%)**

Rating: Sell (1-year period)

Market Cap (USDm): 5,814

Avg 3M daily value traded  
(USDm/day): 16.8

Shares outstanding (m): 14,630

Free float: 31%

Major shareholders:

Hui Ka Yan (Xu Jiayin), 69.1%

Deutsche Bank, 5.41%

Value Partners, 5.02%

Janus Capital, 2.9%

Share performance (see pg3)



## Company analysis and competitive positioning: “Premium Standardisation”

**Top-10 Chinese real-estate developer.** Evergrande is predominantly a property developer (98% of revenues) with the rest recurring income from investment properties and property management. As of FY13, it had 291 projects in 147 cities, with an additional 151m sqm in land reserve. Of the 223 projects currently for sale, c.80% are old projects, c.20% new.

**Mass-market, tier-3 focused strategy: largest developer by saleable area, low average selling prices (ASP).** Historically, Evergrande has relied on volume and low prices to penetrate the mass segment. It lowers costs through standardised designs and construction, and centralised procurement and land tenders. It acquired land at lower average prices than peers thanks to its first mover status in lower tier cities, where local governments frequently accepted lower prices for the largest land parcels in return for increased economic activity and the corresponding tax revenue. Evergrande then builds an entire township including amenities such as schools and community centres on these large lots, and prices its apartments much cheaper than competitors', some which do not even offer similar amenities. Additionally, with the average flat price very affordable at 4-5 times annual income (2013 ASP of RMB6,741 psm vs peers RMB >9,000 psm), these apartments are attractive to middle-class families. As a result, Evergrande was less badly affected by the industry downturn in 2011.

**Aggressive land grab in 2013, doubling land cost average with shift to tier-1 cities.** Although Evergrande has had an aggressive track record of expansion through land acquisitions, it both intensified acquisitions and diversified into 1<sup>st</sup>-tier cities during 2013. It acquired new land reserves of 26.9m sqm (66 projects), of which 34 projects or 51.5% were located in first and second-tier cities (+23.9pp), at a cost of RMB30bn (US\$5bn).

## Industry analysis: “Are they trying to kill us?”

**Residential property development market fragmented with many private developers.** China Vanke, the largest property developer in 2012, had only a 2% market share according to Harvard Business School. Similarly in 2013, the top-10 property developers combined had a 13.3% share of total sales (+0.5% from 2012; by floor area, 8.4% and +0.65%).

**Land prices at record highs, with local governments as beneficiaries.** Average land prices in 105 cities across China rose 7% in 2013 from the previous year, while the full-year supply of land for housing grew 26.8% to 200,000 hectares, according to China's Ministry of Land and Resources. Also, according to the Ministry of Finance, local governments earned a record CNY 4.1tn (USD676bn) in 2013 through selling land-use rights, 44.6% higher from a year earlier. Broker estimates have governments earning a significant proportion of their tax revenue through land sales, and 37% of debt owed by provincial, city and county governments in 2013 was backed by land sales revenues according to China's National Audit Office

**Capital-hungry developers reliant on borrowings in a tightening credit situation: interest costs up.** Property development is a capital intensive business, particularly in China, where land costs are currently at record highs. Home buyers typically pay a 30% deposit for first-timers (70% for second-timers), leaving the developer reliant on project or other financing to fund construction, land, and other development costs; to acquire land in 2013, developers have borrowed an average additional CNY1.3bn. Also, due to credit restrictions after fears of a banking collapse in 2012, developers have increasingly turned to the shadow banking system to raise capital. According to the China Trust Association, real estate trusts held CNY1tn of assets at the end of 2013, after a 120% growth in issuance to 685bn that year, representing 18% of developers' debts. This comes at a cost: Standard Chartered estimates trust financing to cost between 10-12%.

**Demand drying up: first time buyers exhausted after 2012 euphoria.** According to the 2014 China Household Finance Survey (c.28k household participants), first-time buyers comprise only 20% of those interested in purchasing a home, compared to 48% in 2012 and 90% in 2000. Also, more than 55% of households purchasing new homes this year already own one home, compared with 43% in 2013, with 21% of Chinese urban households owning more than one home.

**Falling property prices: they built it, but fewer are buying, and vacancy rates are rising.** According to Shanghai Yiju Real Estate Research, close to 20 cities have inventory of more than 15 months, including Tianjin, Hangzhou, and Shenyang. Wenzhou tops the list with inventory of 42 months. Also, according to the 2014 China Household Finance Survey, the average vacancy rate is 22.4% (+1.8%), with affordable housing slightly higher at 23.3%. Upcoming supply will thus weigh on the market this year, particularly in areas with lower end-user demand, such as in some third- and fourth-tier cities.

**Expect more consolidations.** Luxury property developer Greentown China Holdings is selling a USD 813m stake to Sunac China Holdings, amid a 4% decline in Greentown's sales from Jan-Apr 2014. Song Weiping, chairman of Greentown, explained his decision to sell with some choice words, exclaiming, “Are they trying to kill us?”

**Peer valuation**

**Consensus is neutral on Evergrande; we think otherwise.** Of the 27 analysts covering Evergrande, the average rating is a Hold, with a 12-month target price of 3.64, 18% above the last close price of 3.08. However, there were some early downgrades of Evergrande – we note BNP downgraded it on increasing debt levels as early as 2H13, with the sell calls picking up recently (Barclays, Deutsche) in April/May 2014.

Coverage	Buys	Holds	Sells	12M Tgt Px
27 (3.64)	12 (44.4%)	33.3% (9)	22.2% (6)	3.64 (19/27)

Source: Bloomberg

**We value Evergrande at 2.7x FY15 consensus P/E (50% of peers).** With management departures, tight credit and falling property prices on oversupply coinciding in FY14, we think Evergrande should trade at a hefty discount to peers as it is by far the most indebted and exposed. Should there be a nationwide fall in property prices – whether a gradual and slight decline of 5-10% or a collapse triggered by marginal developers going bankrupt and slashing prices to clear inventory... we think Evergrande should trade according to its risk profile which is the highest among peers, especially as it has significant refinancing risks in 2015/2016. In the preceding 1-year, Evergrande has outperformed a basket of peers (see page 4) and the broader Bloomberg China property developer index, kept aloft by its dividend and share buybacks.



We note our valuation is supported by NAV models (Deutsche) with a hefty discount of 50% due to gearing.

**Risk analysis**

**Key risks to operations.** Newsflow has consistently been negative for China residential property in 1H14; with bankruptcies (Zhejiang Xingrun and Shanghai Yuehe), extreme promotional measures such as 5-year home buybacks and deposit co-payment, and finally nation-wide property price indices registering declines. Additional credit restrictions especially for trust financing and perpetual securities would further worsen Evergrande’s situation, as would a decline in their sell-through rates and average selling prices. However, we note that Evergrande’s much lower average selling prices should not be hit as hard as other developers as Evergrande’s apartments are still relatively affordable at 4-5x annual income.

**Key risks to valuation.** The Chinese government could stimulate the residential property market in two ways: i) ease credit restrictions on developers, allowing them to borrow to buy land, for instance; ii) ease home ownership restrictions. Local governments have begun to roll back measures, but this is limited to cities with the worst oversupply problems e.g. Hohhot, Wenzhou. If there is a nationwide rollback of existing restrictions, it could possibly provide upside to prices and Evergrande would disproportionately benefit as it has the largest exposure to the market.

## Peer valuation comparison table

Name	Market Cap (USDm)	Avg daily value traded 3M (USDm)	Free float (%)	Net gearing (%)	Interest coverage (T12M)	P/E			EV/EBITDA			P/B			ROE			Dvd 12M Yld - Net
						T12M	T+1	T+2	T12M	T+1	T+2	T12M	T+1	T+2	T12M	T+1	T+2	
Evergrande	5,814	24	31	185	2.3	3.1	3.4	0.5	6.93	5.56	4.92	0.82	0.52	0.48	29.04	17.76	18.70	17.4
Guangzhou R&F	4,087	11	96	131	3.1	3.3	3.4	0.5	6.02	4.68	3.89	0.79	0.60	0.53	26.07	18.96	19.79	7.9
Shimao	6,613	31	35	62	3.1	5.5	3.9	0.6	7.87	4.60	3.23	0.98	0.73	0.63	19.03	19.63	20.38	5.3
Agile	2,462	13	36	89	3.7	2.9	2.9	0.4	6.16	4.92	5.04	0.52	0.40	0.36	18.80	14.16	14.27	8.6
COLI	20,651	89	47	28	10.6	6.9	5.9	0.9	8.65	4.52	3.14	1.46	1.06	0.91	23.37	19.38	19.12	2.4
Country Garden	7,550	20	28	81	3.1	5.4	3.9	0.7	8.05	4.57	4.27	1.07	0.79	0.68	20.89	21.50	21.78	6.6
Franshion	2,388	3	32	45	3.8	4.4	4.1	0.4	8.18	4.58	3.21	0.64	0.47	0.43	14.61	11.87	11.66	4.7
COGO	1,449	5	28	61	6.8	3.6	2.8	0.5	5.62	2.11	1.99	0.99	0.62	0.50	32.55	25.28	24.22	2.2
Vanke	15,098	118	78	45	3.7	5.9	4.0	0.7	5.94	4.16	3.40	1.16	0.82	0.69	21.49	20.97	21.03	5.0
Gemdale	6,307	60	86	44	1.7	11.3	7.4	0.9	-	9.20	8.08	1.34	1.07	0.90	13.10	13.70	14.19	-
Glorious	1,106	0	32	89	0.1	22.0	5.0	0.3	-	8.48	11.37	0.37	0.30	0.31	1.60	4.70	5.20	0.0
Kaisa	1,586	2	39	70	1.9	3.3	2.3	0.3	5.88	2.55	0.80	0.55	0.42	0.34	18.06	19.04	22.02	6.1
Shui On	1,972	3	43	77	0.7	5.5	9.0	0.3	23.69	14.37	11.24	0.34	0.29	0.27	6.28	3.22	4.44	3.2
New World China	5,231	29	29	31	3.0	7.1	7.9	0.6	6.77	5.84	5.36	0.70	0.65	0.59	10.38	9.11	7.90	1.7
Poly Property	1,552	8	55	94	1.2	4.4	4.6	0.3	10.51	8.28	7.43	0.41	0.36	0.33	9.58	8.04	8.67	6.8
Sino-Ocean Land	3,848	3	60	54	2.4	4.8	5.5	0.5	9.02	6.16	4.85	0.58	0.49	0.45	10.41	9.20	10.62	5.8
SOHO China	4,133	5	37	18	5.7	3.3	19.5	0.6	4.93	20.42	24.61	0.69	0.61	0.60	21.68	3.58	2.79	5.1
CIFI	1,120	1	27	68	2.0	3.5	2.7	0.5	6.44	3.32	-	0.81	0.55	0.46	24.99	21.63	23.31	4.8
KWG	1,695	5	39	64	1.3	3.8	3.1	0.4	8.43	4.74	3.57	0.59	0.47	0.41	16.62	16.16	16.76	8.0
Sunac	1,975	8	43	86	2.4	3.8	2.2	0.4	5.28	2.61	1.30	0.90	0.54	0.41	27.53	27.86	25.95	5.2
Longfor	6,818	5	22	59	3.8	5.3	5.0	0.7	7.26	4.47	3.01	1.14	0.83	0.70	24.03	17.67	18.38	2.9
China Resources Land	10,804	33	32	39	7.2	5.7	6.0	0.7	9.29	5.50	4.71	0.99	0.76	0.68	19.10	13.73	13.97	3.0
Simple average	5,194	22	43	69	3.3	5.69	5.19	0.53	8.04	6.17	5.69	0.81	0.61	0.53	18.60	15.32	15.69	5.37

Source: Bloomberg, analyst estimates

## Financials

Income statement (RMB m)	FY 2011	FY 2012	FY 2013	FY 2014F	FY 2015F
Revenue	45,801	61,918	65,261	93,672	105,214
Gross profit	20,608	18,210	27,649	31,038	34,945
EBITDA	15,861	12,447	19,780	22,201	24,494
EBIT	10,374	15,513	11,859	18,753	21,845
Net interest income	0	54	34	0	0
Profit before tax	20,375	16,490	25,396	21,683	24,318
Tax expense	8,648	7,308	11,687	0	0
Net profit	11,324	9,171	13,268	10,555	11,430
Profit ex fair value gains	6,117	9,335	6,699		
Gross profit	45%	29%	42%	33%	33%
EBITDA margin	35%	20%	30%	24%	23%
EBIT margin	23%	25%	18%	20%	21%
Net profit margin	25%	15%	20%	11%	11%
EBIT margin ex fair value gains	23%	25%	18%		
EBT margin ex fair value gains	23%	26%	18%		
Net profit margin ex fair value gains	13%	15%	10%		

Balance sheet (RMB m)	FY 2011	FY 2012	FY 2013
Cash and equivalents	20,082	17,790	40,118
Development properties	91,380	133,294	160,544
Completed properties held for sale	8,435	15,159	24,289
Trade and other receivables	5,766	5,785	9,512
Other current assets	19,736	21,117	41,381
Restricted cash	8,122	7,399	13,535
Total current assets	153,521	200,544	289,378
Property and equipment	4,864	8,559	11,378
Land use rights	446	2,347	2,796
Investment properties	18,919	24,942	36,039
Development properties	0	0	355
Other non-current assets	1,273	2,599	8,202
Total non-current assets	25,502	38,447	58,770
Short-term borrowings	10,228	19,031	35,796
Trade and other payables	49,196	77,788	99,895
Other current liabilities	40,379	53,559	52,506
Total current liabilities	99,803	150,378	188,198
Long-term borrowings	41,499	41,243	73,021
Other non-current liabilities	2,864	5,678	7,587

<b>Total non-current liabilities</b>	44,363	46,921	80,608
<b>Total assets</b>	179,023	238,991	348,148
<b>Total liabilities</b>	144,166	197,299	268,806
<b>Net assets</b>	34,858	41,691	79,343
<b>Shareholder's common equity</b>	32,687	38,264	48,590
<b>Non-controlling interests</b>	2,171	3,428	5,729
<b>Perpetual securities</b>	0	0	25,024
<b>Total equity</b>	34,858	41,691	79,343

<b>Cash flow statement</b>	<b>FY 2011</b>	<b>FY 2012</b>	<b>FY 2013</b>
<b>Profit for the year</b>	11,785	9,182	13,709
<b>D&amp;A</b>	348	588	1,027
<b>Change in working capital</b>	-11,829	-5,706	-45,178
<b>Other</b>	-4,039	-9,638	-8,429
<b>Cash used in operating activities</b>	-3,736	-5,574	-38,871
<b>Capex</b>	-9,222	-7,618	-12,259
<b>Investment in JV</b>	-1,331	0	-109
<b>Other</b>	334	-192	-767
<b>Cash used in investing activities</b>	-10,218	-7,810	-13,134
<b>Increase in debt (net)</b>	20,256	9,087	48,905
<b>Perpetual capital securities</b>	0	0	24,367
<b>Dividends</b>	-1,902	-2,801	-2,292
<b>Share buybacks</b>	-546	0	0
<b>Other</b>	3,945	4,809	3,432
<b>Cash from financing activities</b>	21,753	11,095	74,412
<b>Beginning cash</b>	12,356	20,082	17,790
<b>FX</b>	-73	-3	-78
<b>Ending cash</b>	20,082	17,790	40,118

Net change in debt (USD m)					
	2013	2012	2011	2010	2009
Evergrande Real Estate Group L	9,243	2,852	3,647	2,642	637
Guangzhou R&F Properties Co Lt	5,930	640	540	360	189
Agile Property Holdings Ltd	1,435	(488)	2,301	2,626	1,051
KWG Property Holding Ltd	2,806	(163)	1,086	1,459	112
Shui On Land Ltd	1,469	1,628	46	2,854	(44)
Sino-Ocean Land Holdings Ltd	3,717	1,670	1,401	785	881
Longfor Properties Co Ltd	233	779	595	322	937
Poly Property Group Co Ltd	1,062	556	268	79	15
China Vanke Co Ltd	1,315	4,992	1,827	3,469	(1,486)
CIFI Holdings Group Co Ltd	1,124	(710)	2,271	1,304	656
China Overseas Grand Oceans Gr	514	(500)	705	1,674	(474)
China Overseas Land & Investme	1,288	473	934	38	131
Country Garden Holdings Co Ltd	(118)	1,515	2,248	1,263	189
China Resources Land Ltd	1,043	758	832	(542)	660
Franshion Properties China Ltd	(17)	953	1,503	3,141	573
Glorious Property Holdings Ltd	678	(636)	1,403	1,695	811
Kaisa Group Holdings Ltd	(838)	755	248	650	52
Shimao Property Holdings Ltd	137	389	680	394	-
SOHO China Ltd	898	469	393	500	614
Sunac China Holdings Ltd	655	2,163	680	451	(15)
Gemdale Corp	1,493	1,647	1,186	982	(917)
New World China Land Ltd	2,895	(3,323)	4,608	2,145	533





**Q&A with management (Email sent 27 June 1159, reply received 2 July 1639. Calls not picked up)**

Hi Sharon,

Thank you for your interest in our company, here below are the answers to your questions:

1. How does Evergrande intend to finance this dividend payout?

The dividend will be paid out by cash as we have enough cashflows. By the end of 2013, we have more than 53,000,000,000RMB cash reserves.

2. In light of Evergrande's recent downgrade by S&P to B+, what are the company's plans to refinance the USD750m Reg-S bonds expiring January 2015?

We will be continually seeking the right moment to refinance the bonds, however, if there is no opportunity to refinance, we will consider to pay it by our cash reserves.

3. Any target gearing ratio? Evergrande has recently greatly increased its gearing along with other property developers.

The half year gearing target is 60%-70%

4. Is Evergrande planning to refinance the perpetual securities on its balance sheet?

There is no refinancing plan on the perpetual securities on our balance sheet. But there will be a slight increase in our perpetual securities over times.

5. Is the company planning to initiate a share buyback programme, or other changes to the capital structure for instance issuance of equity?

As far as we know, there is no such plan at the moment.

6. Evergrande has thus far completed 51.1% of its annual sales goal of RMB110 billion. In light of recent negative property market sentiments, what is Evergrande doing to reach its sales targets, other than existing measures?

We have a very strong execution power, and in 2013, we have replenished plenty of quality projects in the urban area, as well as improved interior designs. In addition, we have also launched promotions from time to time to stimulate the sales too.

Many Thanks,

Becky

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Becky Wang 王琪

Evergrande Real Estate Group

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