Zhongliang Holdings Group Company Limited

Surveillance Report

Summary	
Issuer Rating	BB
Outlook	Stable
Location	China
Industry	Homebuilder and Real Estate
Date	11 February 2021

Lianhe Ratings Global Limited ("Lianhe Global") has affirmed 'BB' global scale Long-term Issuer and Issuance Credit Rating to Zhongliang Holdings Group Company Limited; Issuer Rating Outlook is Stable

Summary

The Issuer Rating reflects Zhongliang Holdings Group Company Limited's ("Zhongliang" or "the company") established market position and large footprint in the Yangtze River Delta Region. Zhongliang maintains substantial JV participation across its footprint. Zhongliang has exhibited a strong operating efficiency in terms of standardized process and products, sales execution, and high cash collection rate via its decentralized projection teams but centralized financial control.

However, Zhongliang's rating is constrained by its elevated financial leverage as a result of debt-funded expansion in the prior years. Zhongliang's liquidity will be tight if it does not control its capital expenditure in a prudent manner.

The Stable Outlook reflects our expectation that Zhongliang would expand its operating scale in a prudent manner especially regarding land acquisitions, while continuing maintaining its stable growth.

Rating Rationale

Strong Market Position and Coverage in Lower-Tier Cities Resulting in Low Profit Margin: Zhongliang has established a strong market position and well-recognized brand name as a result of robust contracted sales growth, underpinning by strong housing demand in lower-tier cities over the past three years. Zhongliang's ranking was improved to 20th place in 2020 from 40th place in 2016 in terms of gross contracted sales according to CRIC. Zhongliang reported gross contracted sales of RMB168.8 billion and maintained its top 20 market position in 2020. Nevertheless, Zhongliang has employed a quick asset turnover strategy which resulted in relatively lower gross margins in the low 20's% over the past 3 years.

Shifting Gears by Focusing on Higher-Tier Cities: As the momentum of shantytown renovation recedes (in terms of both government subsidies and remaining units), Zhongliang has turned its focus back to tier-2 cities in the Yangtze River Delta Region since 2H2018. Its focus on the Yangtze River Delta Region makes the strategic shift to tier-2 cities within the region easier. Yet, the company stays true to its strategy of low-cost land, small project footprints, quick asset turnover, high sell-through and cash collection rates, which limits the upside of gross margin. Zhongliang increased its land purchase proportion in the tier-2 cities to 64% and the tier 3-cities to 27% in 1H 2020.

Strong Execution Supports Cash Collection and Business Growth: Zhongliang has adopted a quick asset turnover strategy primarily targeting first-time home buyers and first-time upgraders in less sought-after cities with latent demands while avoiding competitions on land purchase and property price. The company keeps the size of individual projects relatively small (i.e. c. 85% of the project GFA was less than 200,000 sq.m. or c. 87% of the project land cost was less than RMB500 million at end-2020) to reduce execution risk and keep inventories low.

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Applicable Criteria
General Corporate Rating Criteria (16 July 2018)

We are of the view that Zhongliang's high growth rate may reach its plateau especially when a vast majority (i.e. 45.5%) of its land bank was in the Yangtze River Delta Region at end-June 2020 where there is intense competition. We expect its contracted sales growth rate to slow to 10-15% year-on-year after 2020 and onward, compared with the high CAGR of c. 55% in terms of contracted sales from 2016 to 2020. The company's strong execution would continue to support its high cash collection rates which were at 90%, 90%, 99%, 99% and 87% in 1H2020, 2019, 2018, 2017, and 2016 respectively. Nevertheless, we expect cash collection rates to decline as the company enters more tier-2 cities which may be subject to policy risks.

High Financial Leverage Constraints Rating: Zhongliang needs to keep purchasing land to sustain its contacted sales growth as it adopts a quick asset turnover strategy with its land bank only sufficient to support its contracted sales for the next 2-3 years. In general, Zhongliang directs approximately 40% (decreased from 50% to 60%) of the cash collected from contracted sales toward land acquisitions. In addition, the acquisitions of more land parcels in tier-2 cities could drive up its land costs, although the company continues to avoid highly-sought locations/cities with intense competition. Zhongliang's reported debt increased to RMB52.8 billion at end-June 2020 from RMB40 billion at end-2019. We expect Zhongliang to continue using debt borrowing to finance its property projects and its financial leverage as measured by debt over capitalization ratio to remain high at about 65%-70% in the next 12 to 18 months.

Zhongliang had cash and liquid investments on hand totaling RMB35 billion (including restricted cash of RMB13.6 billion and pledged deposits of RMB1.86 billion), and the total debt due in the next 12 months was approximately RMB23 billion at end-June 2020. Zhongliang had a total bank credit line of RMB51.3 billion, of which RMB29.28 billion was unused at end-June 2020. The company also had contracted for but unpaid commitment of c. RMB 81 billion (of which RMB 69.2 billion was for property development activities, RMB 7.7 billion was for land acquisitions, and the remaining RMB 4.1 billion was for payments to JVs and associates) at end-June 2020. The company's strong contracted sales proceeds may partially alleviate its liquidity pressure.

We expect Zhongliang to improve its funding structure by reducing debt from non-bank financing channels which usually have shorter duration and higher cost. Short-term debt accounted for 43.5% of Zhongliang's total debt at end-June 2020, improving from 53.5% at end-2019.

High Percentage of JV Contribution: Zhongliang reported high JV participation with total non-controlling interests accounting for c. 65% and c. 58% of the total equity at end-June 2020 and end-2019, respectively. We expect the ratio to remain in the same range as the company expands into more tier-2 cities via JV participation. This approach helped Zhongliang control its overall land acquisition cost. We expect Zhongliang to maintain an overall attributable ratio at c. 60% on average. However, the decrease in the overall interest in the acquired land bank by increasing the JV participation rate will likely impose execution risks for Zhongliang and lower its financial transparency, in which the company consolidates c.70% of its projects onto the balance sheet. In addition, Zhongliang has been relying on capital contributions from non-controlling shareholders for financing its business.

Rating Sensitivities

We would consider downgrading Zhongliang's rating if it were to (1) aggressively replenish its land bank which result in an increase in its financial leverage as measured by debt/capitalization to over 75% or a decrease in its EBITDA interest coverage to below 2.0x consistently, and/or (2) its operating performance were to deteriorate such that its contracted sales and/or revenue experience a material decline or liquidity profile is worsened.

We would consider upgrading Zhongliang's rating if it were to (1) considerably increase its operating scale, and (2) maintain its financial leverage as measured by debt/capitalization at below 60% or EBITDA interest coverage at above 3.0x consistently.

Company Profile

Zhongliang is headquartered in Shanghai and it is principally engaged in real estate development in China with a national footprint. It was listed on the Main Board of the Stock Exchange of Hong Kong Limited (Stock Code: 2772.HK) on 16 July 2019. Zhongliang strives to develop quality residential properties targeting first-time home purchasers, first-time and second-time home upgraders. It is also engaged in the development, operation and management of commercial properties and holds a portion of such commercial properties for future investment purpose. The company adopts a quick asset turnover business model and standardized real estate development process for developing the projects in the second-, third- and fourth-tier cities. As a result, the company has well-established the "Zhongliang" brand name nationwide. It was ranked first among the top ten real estate developers in China in terms of growth rate in 2018 and development potential in 2019, respectively, recognized by China Real Estate Association and E-house China R&D Institute China Real Estate Appraisal Center.

Zhongliang's Shareholding Structure (at end-June 2020)

Shareholder	Percentage
Yang Jian	82.94%
Public	17.06%
Total	**100.0%**

Source: Bloomberg

Key Financial Assumptions

- Contracted sales amount: RMB168 - 204 billion for 2020-2022
- Contracted average selling price: RMB12,500 - 13,500 for 2020-2022
- Total revenue: RMB61- 68 billion for 2020-2022

Key Financial Metrics

2018A-2022F	Debt/Land Bank	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Average	34.9%	2.38x	71.86%	0.35x

Source: Zhongliang's 2018-2019 annual and 2020 interim reports, Lianhe Global's adjustments and forecasts

Full List of Issuance Ratings

A full list of affirmed issuance ratings is included below. Any rating action on Zhongliang's rating would result in a similar rating action on the USD notes:

- USD450 million 9.5% senior unsecured notes due 2022 affirmed at 'BB'

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