

LVGEM (China) Real Estate Investment Company Limited

Surveillance Report

Summary

Issuer Rating	BB-
Outlook	Stable
Location	China
Industry	Homebuilder and Real Estate
Date	21 January 2022

Lianhe Ratings Global Limited (“Lianhe Global”) has affirmed ‘BB-’ global scale Long-term Issuer and Issuance Credit Rating of LVGEM (China) Real Estate Investment Company Limited; Issuer Rating Outlook is Stable

Summary

The Issuer Rating reflects LVGEM (China) Real Estate Investment Company Limited’s (“LVGEM” or “the company”) established track record of above-average profit margin, specialized management expertise in the urban renewal industry, and its focus on the Greater Bay Area (GBA), including the Baishizhou project which so far marks the record-large redevelopment project in Shenzhen. However, LVGEM’s rating is constrained by its modest business scale in terms of contracted sales, moderate liquidity profile with basic source of funding, and high concentration risks given its revenue drivers rely on a limited number of projects under development.

The Stable Outlook reflects our expectation that LVGEM would expand its operating scale in a prudent manner following its stake increase in the Baishizhou redevelopment project. It also reflects our expectation that LVGEM will maintain its competitive edge and niche strategy in the urban renewal industry while maintaining an adequate financial profile without a material increase in financial leverage in the near term.

Rating Rationale

Niche Player with Regional Focus on the GBA: LVGEM is a Chinese property developer focusing on mass residential property development and commercial property operation. LVGEM concentrates on developing undervalued shantytown renewal projects in Shenzhen and the GBA in Guangdong province. Driven by this unique business model, LVGEM positions itself as a niche regional property developer and operator with a relatively narrow geographical focus of its business. LVGEM’s operating scale is relatively small with its land bank of 8.68 million square meters (sqm) of total GFA at end-June 2021. LVGEM achieved contracted sales of RMB4.48 billion and RMB2.14 billion in 2020 and 1H2021, respectively.

Given its niche business strategy, LVGEM is able to gain competitive advantages over its peers in terms of profit margins and average selling prices (ASPs), which partially offset its small operating scale in terms of contracted sales metrics, uncertainty or delay of redevelopment projects’ schedules, moderate land bank size and the limited number of projects under development.

Development of Flagship Baishizhou Project Underway: Following the connected transaction with its controlling shareholder in August 2020, LVGEM completed the injection of its flagship project, namely the Baishizhou urban renewal project, by increasing its project stake to 80% (from 25%) at a minimal consideration of RMB4.07 million. We believe the transaction would help removing the uncertainty regarding the ownership of this project, and avoiding a heavy burden of extra payment to LVGEM’s controlling shareholder at the early redevelopment stage.

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Applicable Criteria

Chinese Property Developer Rating
Criteria (31 December 2021)

LVGEM has been and will continue relying on property sales proceeds from both new and existing projects to support its contracted sales until the presale commencement of the Baishizhou project. Once the Baishizhou project launches presales, LVGEM's cash flow position will be greatly improved given the expected cash inflow from this project. The Baishizhou project consists of a total GFA of 3.58 million sqm. The redevelopment stage of phase one is underway currently and we expect LVGEM to commence presales in 2H2022 or 1H2023.

Uncertainties Associated with the Marquee Urban Renewal Project Largely Capped: LVGEM now holds 80% of equity in the Baishizhou project. Given the 100% signing rate on phase 1 and the high signing rate of c. 90% on phases 2, 3, and 4 of the Baishizhou project, we believe the uncertainties associated with this urban renewal project are largely capped. The company plans to start presale phase 1 of the project with a saleable GFA of c. 300,000 sqm in either 2H2022 or 1H2023, with the rest of the project with a saleable GFA of c. 1.5 million sqm to be launched phase-by-phase to the market from 2024 and onward. In addition, the Baishizhou project will likely command high ASPs given its prime location of Nanshan District in Shenzhen. We expect the Baishizhou project to support LVGEM's contracted sales and revenue growth in the near and medium terms. However, the uncertainty on policy risk under the backdrop of "reference price" on the secondary market in Shenzhen as well as any potential resurgence of the COVID-19 variants may pose pressure on the company projects' ASPs and the contracted sales schedules.

Above-Average and Sustainable Gross Margin: As mentioned, the focus on undervalued redevelopment projects in prime locations and cities in the GBA enabled LVGEM to achieve a track record of above-average gross margin. LVGEM's gross margin reached 64.2%, 49.1%, and 47.5% in 2019, 2020, and 1H2021, respectively, which was significantly higher than the industry average. LVGEM's gross margin will likely experience some fluctuations going forward, given the limited number of projects. However, we foresee LVGEM to sustaining the competitive advantage in profit margin, as the company sits on a number of low-cost projects whose sell-through rates are secured by their prime locations.

Two-Pronged Growth Strategy: LVGEM plans to retain a certain proportion of the commercial space including those in the Baishizhou project as investment properties. LVGEM undertakes a two-pronged growth strategy of discovering and delivering undervalued land from urban renewal projects to boost its gross margin as well as retaining commercial space including office and mall areas as investment properties to generate recurring and stable revenue to complement its property development segment. While the recurring revenues from investment properties represented less than 20% of the annual total revenue on average in the past five years, they did offer revenue diversity to LVGEM's revenue structure especially during time of violate contracted sales.

High Financial Leverages and Moderate Liquidity: LVGEM reported high financial leverages over the past three years, as measured by average debt over capitalization ratio of above 60% and an average interest coverage of about 2x in 2018-2020. LVGEM reported a cash balance of RMB8.0 billion against a short-term borrowing of RMB10.1 billion at end-June 2021. LVGEM passed 2 out of the 3 metrics stated in the "3 Red Lines" policy. The management expects to meet the threshold by 2023. On the financing front, LVGEM has already secured a bank line of c. RMB20.7 billion from China Everbright Bank (and among others) solely for the Baishizhou project.

Rating Sensitivities

We would consider downgrading LVGEM's rating if it were to (1) aggressively increase its financial leverage as measured by debt/capitalization to over 70% or a decrease in its EBITDA interest coverage to below 2.0x consistently, and/or (2) its operating performance were to deteriorate such as a material decline in net cash inflow from operating activities, contracted sales and/or revenue for a sustained period or liquidity profile is worsened.

We would consider upgrading LVGEM's rating if it were to (1) considerably increase its operating scale, and (2) lower its financial leverage as measured by debt/capitalization at below 60% or increase its EBITDA interest coverage at above 4.0x consistently.

Company Profile

LVGEM is a Chinese property developer that mainly focuses on mass residential property development and commercial property operation in China. It was established by Mr. Wong Hong King in Shenzhen in 1995 and commenced its first property development project in 1998. The company issued a share offer with the intent to buy back shares issued by New Heritage Holdings Ltd. ("New Heritage"), a property developer listed on Hong Kong Stock Exchange (95.HK) since 2005, in 2014. After the acquisition at HKD940 million (HKD1.1 in cash for each offer share), the company owned 64.83% of New Heritage and became its major shareholder. The stock code of New Heritage has remained unchanged but the name has been changed to LVGEM (China) Real Estate Investment Company Limited.

LVGEM is majority-owned and controlled (70.6%) by Mr. Wong Hong King, the father of LVGEM's current Chairman, Ms. Huang Jingshu and one of its Executive Directors, Mr. Huang Haoyuan. At end-June 2021, China Vanke Co., Ltd. (through Wkland Investments V Limited) and Ping An Insurance (Group) Company of China, Ltd. (through Toplist Investments) are the second and third largest shareholders, respectively. Each of them holds 5.9% of the company's shares.

LVGEM's Shareholding Structure (at end-June 2021)

Shareholder	Percentage
Mr. Wong Hong King (through 100%-owned Go Great and Cantrust)	70.5%
Ping An Insurance (Group) Company of China, Ltd.	5.9%
China Vanke Co., Ltd.	5.9%
Public	17.7%
Total	100.0%

Source: LVGEM

Key Financial Assumptions

- Contracted sales amount: RMB3.8 – 8 billion for 2021-2023
- Contracted average selling price of c. RMB18,000 for 2021-2023
- Total revenue: RMB4.4 – 7.5billion for 2021-2023

Key Financial Metrics

2019A-2023F	Debt/Land Bank	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Average	93%	1.5x	51%	0.4x

Source: LVGEM's 2019-2020 annual and 2021 interim reports, Lianhe Global's adjustments and forecasts

Full List of Issuance Rating

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

- USD470 million 12.0% senior unsecured notes due 2023 affirmed at 'BB-'

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