

LVGEM (China) Real Estate Investment Company Limited

Surveillance Report

Summary

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|---------------|-----------------------------|
| Issuer Rating | B |
| | Rating Watch Negative |
| Location | China |
| Industry | Homebuilder and Real Estate |
| Date | 20 January 2023 |

Lianhe Global downgrades LVGEM (China) Real Estate Investment Company Limited's global scale Long-term Issuer and Issuance Credit Ratings to 'B' from 'BB-'; on Rating Watch Negative

Summary

The Issuer Rating downgrade to 'B' reflects LVGEM's increasing refinancing pressure as it faces a tall maturity wall in both its offshore USD notes and certain onshore RMB bonds that are coming due in 2023, which puts constraint on its liquidity. The Issuer Rating also reflects LVGEM's established track record of above-average profit margin 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 franchise in terms of contracted sales scale and significant concentration risks given its land bank locations and revenue drivers relying on the limited number of projects under development.

The RWN reflects our expectation of LVGEM's exposure to short-term repayment burden, which puts pressure on its liquidity and heightens the uncertainty on its current financing situation which could impact its repayment capability. We would remove the RWN when the company has demonstrated its capability to manage its maturing financial obligations in the near to medium terms.

Rating Rationale

Higher Financial Leverages Burden: LVGEM's reported total debt rose to RMB32.8 billion at end-June 2022, compared with RMB30.7 and 31.2 billion at end-2020 and end-2021, respectively. On the other hand, LVGEM's total cash balance (including restricted cash) decreased to RMB5.7 billion at end-June 2022, compared with RMB9.4 and 7.3 billion at end-2020 and end-2021, respectively. Excluding restricted cash, LVGEM's cash balance decreased to RMB2.7 billion at end-June 2022, compared with RMB5.4 and 3.9 billion at end-2020 and end-2021, respectively. It was mainly due to the development cost incurred in the Baishizhou project. Consequently, LVGEM reported high financial leverages over the past three years. LVGEM's reported net gearings rose to 89.4% at end-June 2022, compared with 76.2% and 81.2% at end-2020 and end-2021, respectively.

Also, short-term debt accounted for c. 38% of the total debt at end-June 2022, compared with c. 32% at end-2021, as the USD470 million bond due 2023 was classified as short-term debt.

Tight Liquidity: As mentioned, LVGEM reported a total cash balance of RMB5.7 billion (or RMB2.7 billion if restricted cash was excluded), against a short-term borrowing of RMB12.6 billion at end-June 2022. Moreover, LVGEM will face a tight repayment schedule given its c. USD470 million of offshore bond and c. RMB900 million of convertible bonds will due in March and May 2023, respectively. On the financing front, LVGEM secured a bank line of c. RMB20.7 billion from China Everbright Bank (and among others) solely for the Baishizhou project. We expect LVGEM's exposure to the upcoming maturity wall in 2023 would put pressure on its liquidity and heighten the uncertainty on its repayment capability.

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Applicable Criteria

[Chinese Property Developer Rating Criteria \(31 December 2021\)](#)

Niche Player with Regional Focus on the GBA: 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. 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.

LVGEM's operating scale is relatively small with its land bank of 7.4 million square meters (sqm) of total GFA at end-June 2022, of which c. 76% is located in the GBA. LVGEM achieved contracted sales of RMB3.7 billion and RMB2.6 billion in 2021 and 1H2022, respectively.

Development of Flagship Baishizhou Project Underway: The Baishizhou project is LVGEM's flagship urban renewal project which consists of a total GFA of 3.58 million sqm. The construction stage of phase 1 is underway currently. The company plans to commence the presales of phase 1 of the project in 3Q2023. The company also plans to start the presales for the rest of the project from 2024 and onward. In June 2022, a subsidiary of China Vanke Co., Ltd. ("China Vanke") injected c. RMB2.3 billion for acquiring 8% stake of the Baishizhou project. The proceed will mainly be used for the development of phase 3 and 4 of the Baishizhou project.

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 medium terms. LVGEM's cash flow position will also be improved once the presales start, given the huge expected cash inflow from this project. However, the reliance on the Baishizhou project pose a concentration risk to LVGEM. Any delay in construction and/or contracted sales schedule of this project will pose pressure on LVGEM's financial position and repayment capability. We believe LVGEM to continue relying on existing projects for its contracted sales and cash flow until the presale commencement of the Baishizhou project. The capital injection from China Vanke would partially alleviate the capital burden of the company.

Competitive Advantages in Gross Margin: 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. However, given the limited number of projects, LVGEM's gross margin experienced some fluctuations. LVGEM's gross margin reached 49.1%, 50.0%, and 41.6% in 2020, 2021 and 1H2022, respectively, which was significantly higher than the industry average. The gross margin decline in 1H2022 was mainly due to the higher proportion of revenue recognition from projects in Zhuhai and Suzhou, which commanded a lower profit margin compared with projects in Shenzhen. We expect LVGEM to sustain the competitive advantage in gross profit margin at 40-50%, 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 under-valued 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. This strategy offers revenue diversity to LVGEM's revenue structure especially during volatile times of contracted sales.

Rating Sensitivities

We would consider downgrading LVGEM's rating if (1) it were to fail to meet its near and medium term financial obligations when they become due, and/or (2) it were to aggressively increase its

financial leverage as measured by debt/capitalization to over 70% or a decrease in its EBITDA interest coverage to below 1.0x consistently, and/or (3) 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.

An upgrade is unlikely given the RWN on LVGEM. We will resolve this RWN as soon as practicable.

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 c. HKD940 million (HKD1.1 in cash for each offer share), the company and related parties owned c. 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 (74.0%) 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 2022, China Vanke Co., Ltd. is the second largest shareholder, holding 5.9% of the company's shares.

LVGEM's Shareholding Structure (at end-June 2022)

| Shareholder | Percentage |
|---|---------------|
| Mr. Wong Hong King (through 100%-owned Go Great and Cantrust) | 74.0% |
| China Vanke Co., Ltd. | 5.9% |
| Public | 20.1% |
| Total | 100.0% |

Source: LVGEM

Key Financial Assumptions

- Contracted sales amount: RMB4 – 8 billion for 2022-2024
- Contracted average selling price of c. RMB22,000 for 2022-2024
- Total revenue: RMB2.6 – 3.3 billion for 2022-2024

Key Financial Metrics

| 2020A-2024F | Debt/Land Bank | EBITDA/Interest | Debt/Capitalization | Quick Ratio |
|------------------|----------------|-----------------|---------------------|-------------|
| Weighted Average | 74% | 0.7x | 51% | 0.1x |

Source: LVGEM's 2020-2021 annual and 2022 interim reports, Lianhe Global's adjustments and forecasts

Full List of Issuance Ratings

Any rating action on LVGEM's rating would result in a similar rating action on its USD notes and HKD/USD commercial paper notes:

- USD470 million 12.0% senior unsecured notes due 2023 downgraded to 'B' from 'BB-'



- HKD174.6 million and USD8.758 million 6.0% senior unsecured commercial paper notes due 2023 downgraded to 'B' from 'BB-'

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