

Factors to Consider When Analysing Chinese Property Developers

Lianhe Global examines a basket of elements when analysing Chinese property developers. In this commentary, we would like to highlight some of the key factors for investors' attention:

1. Strategic partners/investors

We believe large and financially strong strategic investors are conducive for the growth of a property developer. This type of strategic investors will not only provide additional funding sources and channels, but also give a property developer an advantage in land acquisition costs and channels. However, we do differentiate between a passive investor acquiring equity shares in the open market verse an active investor acquiring equity shares for the purpose of participating in a property developer's operation. We view active investors favourably over passive ones.

2. Attributable contracted sales and land bank figures and their associated liabilities

In China, as land prices stay elevated in recent years, many Chinese property developers resort to joint ventures and/or form partnerships to acquire land to diversify projection execution risk, lower funding hurdles, and/or expand their footprints. For accounting reporting purpose, many property developers report gross figures such as contracted sales and land bank GFA instead of their respective attributable figures. While many publicly listed property developers disclose their attributable figures, not everyone follows suit. As part of Lianhe Global's rating process, we use a standardized request-for-information spreadsheet and questionnaires to ask a property developer to disclose detailed attributable land bank GFA and contracted sales figures etc. We only give credit to and analyse attributable figures.

In addition, Lianhe Global asks a property developer to disclose details of associated liabilities. In general, under the accounting principle, the controlling party should consolidate the associated assets and debts onto its balance sheet. Lianhe Global makes adjustments in our financial analysis for the debt/capitalisation factor.

3. Valuation gain on investment properties and related appraisal methods (i.e. income verse replacement cost approach)

Frequently, Chinese property developers retain a portion of their commercial (to a lesser extent residential) projects as investment properties. Given the elevated land prices in recent years, many of these investment properties have appreciated in value. While under China GAAP, companies are allowed to use either a replacement cost or income approach to evaluate investment properties. We prefer property developers using the income approach which is more appropriate for profit generating commercial properties, as the replacement approach does not reflect the prevailing market value given the rising land

price and construction costs. For the computation of EBITDA, we exclude any unrealized valuation gain. If we deem that there is an excessive valuation gain on a property developer's balance sheet, we may make adjustments in our financial analysis.

4. Contingent liabilities related to third-party guarantees

Frequently, Chinese property developers extend guarantees to third-parties. Lianhe Global treats any third-party guarantee as debt. In general, we consider any third-party guarantee as debt in our debt/capitalisation ratio calculation, while any guarantee related to mortgage loans extended to home buyers are excluded due to their nature and short tenors (usually 3 months).

5. Rental and property management fee incomes

We believe stable incomes from rental and property management fees provide a buttress to a property developer, especially for a small-to-medium size property developer with a limited number of projects under construction which may result in jagged earnings. In general, we measure these stable incomes against a property developer's interest expense (including capitalized interest). With higher stable income versus the interest expenses, a property developer may be insulated from jagged earnings from property sales due to restrictive policies of home price ceiling, sales, purchase, as well as mortgage approvals.

6. Land without land-use rights certificate

Due to a variety of legacy issues ranging from collective ownership to change of land usage, land-use rights certificates may not be immediately available. In general, Lianhe Global only gives credit to land with land-use rights certificates on a property developer's balance sheet. Given the tightened policies on Chinese property developers, banks and local building departments may not release loans and issue certificates to commence construction, respectively, which may adversely affect the pace of construction and project delivery. Subsequently, this will adversely affect the pace of contracted sales and revenue recognition.

In short, these are some of the noteworthy key elements Lianhe Global considers when analysing Chinese property developers. While there are many other key factors, we would like to bring attention to the investing community of the aforementioned factors which have not garnered much attention but are important for a thorough credit analysis.

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