

LVGEM (China) Real Estate Investment Company Limited

Initial Issuer Report

Summary

Issuer Rating	BB-
Outlook	Stable
Location	China
Industry	Homebuilder and Real Estate
Date	27 March 2020

Lianhe Ratings Global has assigned a 'BB-' global scale Long-term Issuer Credit Rating to 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") niche operation model in urban renewal industry, steadfast affinity to business partners, and a tactical land-banking arrangement with its major shareholder, all of which support robust gross margins at approximately 60%.

The rating also considers the anticipated inclusion of Bai Shi Zhou redevelopment project in the Nanshan District of Shenzhen which will likely strengthen LVGEM's land bank quality and size while boosting its business scope.

The Stable Outlook reflects our expectation that LVGEM will maintain its performance metrics and leverage within the rating horizon in the next 12 to 24 months while expanding its operating scale in a prudent manner. Rating constraints include the company's small operating scale, acceptable liquidity profile, and high financial leverage.

Rating Rationale

Niche Strategy and Industry Know-How: LVGEM focuses on redeveloping undervalued shantytown renewal projects in the Greater Bay Area (GBA) with its value-add expertise, industry-specific knowledge, and 25-year experience in the urbanization business. The company differentiates its niche strategy in various aspects from its business performance to the nitty gritty details in different phases of the redevelopment timeline which involve frequent discussions with local governments, collective negotiations with the associations of the incumbent residents, meticulous execution of project plans, and adequate funding management.

The company is able to manage the interminable redevelopment timeline and reduce associated uncertainties by acquiring redevelopment projects mainly from its controlling shareholder's 'project incubator' business units specializing in early-stage negotiations and relocation contract signings. By doing so, the company can largely contain the associated risks of redevelopment. LVGEM's unique approach to shantytown redevelopment both largely shortens the timeline and reduces uncertainties.

Small Operating Scale with Quality Land Bank: Positioned as a regional niche property developer and operator with a relatively narrow geographic focus on its business in the GBA, LVGEM's residential and commercial property development businesses are primarily concentrated in Shenzhen, Zhuhai, Hong Kong, and other cities in the GBA. LVGEM's operating scale is relatively small, as its total land bank by GFA at end-June 2019 was only 4.4 million square meters and its contracted sales amount for the first six months of 2019 was about RMB 4 billion.

Nonetheless, LVGEM's core focus on the GBA gains competitive advantages over the other property developers and competitors with higher sellable asset values as the average price in the

Operating Data:

LVGEM (China) Real Estate Investment Company Limited

	31 Dec 2018	30 Jun 2019
Revenue (RMB: in million)	4,516	3,422
Contracted Sales (RMB: in million)	4,240	4,087
Contracted Average Selling Price (RMB/square meter)	N/A	N/A
Contracted Sales GFA (million square meters)	0.24	0.15
Land Bank GFA (million square meters)	4.32	4.46

GFA: Gross Floor Area

Source: LVGEM's 2018-2019 annual and interim reports

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Applicable Criteria

General Corporate Rating Criteria (16 July 2018)

area is higher. This partially offset its small operating scale in terms of contracted sales metrics, land bank, and limited number of projects under development.

LVGEM aims to improve its market franchise with the upcoming injection of the Bai Shi Zhou redevelopment project with a total planned GFA of 3.58 million square meters, marking it the largest redevelopment project in the Nanshan District of Shenzhen to date. The site sits in a traditional squatter settlement area with about 4,500 households in 1,600 low-rise buildings in the Nanshan District where the average selling price is among one of the highest in the GBA.

Robust Gross Margin Supports Expansion: We expect LVGEM to maintain strong gross margin in the next 12 to 24 months given its execution track record. The company reported above-average gross margins of 65.3%, 59.5% and 70.0% in 2017, 2018 and 1H2019, respectively, primarily because of the company's low-cost land acquisition strategy and its redevelopment projects being in prime locations of the GBA.

The company currently holds 25% equity ownership of the Bai Shi Zhou redevelopment project in the Nanshan District of Shenzhen and plans on acquiring the rest in the near future.

High Financial Leverages and Tight Liquidity: The company reported high financial leverages as measured by a debt over capitalization¹ ratio at above 65% and a weak interest coverage at about 2x at end-2018. The company reported an unrestricted cash balance of RMB 5.84 billion and an unutilized bank credit line of RMB 2.55 billion against a short-term borrowing of RMB 4.37 billion and commitments of RMB 1.67 billion at end-June 2019.

Notwithstanding, we believe these constraints would be partially mitigated through its future cash collections from contracted sales in 2020 and 2021 estimated at approximately RMB 15 billion in aggregate.

Development Timeline Susceptible to Multiple Contributing Factors and Policy Risks: As the urban renewal business often involves various correlative elements and rather complex redevelopment process, from time to time the company faces different risks throughout the trajectory of work-in-progress. Some challenges could take lengthy time to resolve. Each step within the redevelopment process also varies materially among different projects and some of them would require extension/rescheduling as any lagging in certain stages could delay the whole series of processes and ultimately project delivery.

We believe LVGEM's core competency, project management, and strategic focus in such arena will help largely alleviate the associated risks.

Rating Sensitivities

We would consider downgrading LVGEM's rating if it were to aggressively replenish its land bank which result in an increase in its financial leverage as measured by debt/capitalization to over 80% or a decrease in its EBITDA interest coverage to below 2.0x consistently, and/or 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 LVGEM's rating if it were to considerably increase its operating scale, and maintain its financial leverage as measured by debt/capitalization at below 60% or EBITDA interest coverage at above 3x consistently.

¹ Total debt includes LVGEM's reported interest-bearing debt and lease liabilities

Company Profile

LVGEM is a Chinese property developer that mainly focuses on mass residential property development and commercial property operation in China. Established by Mr. Wong Hong King in Shenzhen in 1995, the company commenced its first property development project in 1998. In 2014 LVGEM issued a share offer with the intent to buy back shares issued by New Heritage Holdings Ltd. ("New Heritage"), a property developer listed in Hong Kong Stock Exchange (95.HK) since 2005.

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 since May 2014.

LVGEM is majority owned and controlled (71.4%) by Mr. Wong Hong King, the father of LVGEM's current Chairman, Ms. Huang Jingshu and one of its Executive Directors, Mr. Huang Haoyuan. Ping An Insurance (through Toplist Investments) and China Vanke Co., Ltd. ("Vanke") are both the second largest shareholders and each owned 6.01% of the company's total outstanding shares at end-June 2019.

Business Profile

Unique Market Position with Competitive Advantage

LVGEM's market position is small in terms of total land bank by GFA because unlike other property developers pursuing high turnover with rather aggressive land banking activities, the company focuses on urban renewal/redevelopment projects through close cooperation with local municipal governments in Southeast China by acquiring lands from its major shareholder who controls a sizeable land portfolio.

The management purposely maintained the company's land bank for future development at about 4.4 million square meters in the recent years and only replenished the pool after delivering planned projects. The company took a common control accounting approach to recognize the cost value of lands and project companies acquired from its shareholders, which allowed the company to book the difference between the book value and the acquisition price in the other reserves item under the shareholder's equity rather than goodwill.

However, the company's land bank will likely experience a boost at end-June 2020 as LVGEM intends to include the sellable resources of its flagship Bai Shi Zhou project upon receiving regulatory construction permits which it will apply for after signing all the incumbent residents through the residents' associations.

Albeit the company's limited land bank, we take comfort in the sustainability of its unique business model and expects it to carry out project plans and meet the growth targets in the medium term, given its 1) seasoned expertise in redevelopment that requires specific industry know-how, 2) deep-rooted cooperation with its major shareholder that provides lands without uncertainties of relocation negotiation, and 3) detail-oriented execution arrangements approved by the city government.

Ambitious Growth Plan for Commercial Investment Property

Revenue from property development is LVGEM's major source of income and its contribution to the total revenue enjoyed a rapid increase to 87.3% for the first half of 2019 from 47.6% in 2015. LVGEM mainly focuses on urban redevelopment projects in Shenzhen and other parts of the



Pearl River Delta. The uncertainty of revenue recognition in urban development projects makes its revenue fluctuate.

Revenue from commercial property investment and operations amounted to RMB543 million in 2018 with an annualized growth of 9.6% compared with the amount in 2015. The company recognized a revenue of RMB3,422 million, posting a growth rate of 346% year-on-year in the first half of 2019, mainly from residential property development projects.

The company currently owns, operates and manages a number of quality commercial property projects, mainly represented by two commercial brands, namely “NEO” and “Zoll”, including NEO Urban Commercial complex, LVGEM Zoll Hongwan Shopping Mall, LVGEM Zoll Chanson Shopping Mall, LVGEM Zoll 1866 Shopping Mall, LVGEM Zoll International Garden Shopping Mall, Hong Kong LVGEM NEO and other shops and investment properties, with a total gross floor area of approximately 612,713 square meters.

LVGEM’s commercial property development projects are mainly commercial projects as well as mixed-use projects that comprise commercial areas. Among them, the ancillary services of commercial properties under complex projects significantly increase the overall value of individual residential projects among the real estate development business. Management also plans to retain at least 50% of future commercial real estate as a part of the long-term growth strategy to build its portfolio.

In the first six months of 2019, the company’s revenue from the investments and operations of commercial properties harvested approximately RMB302.3 million (1H2018: RMB273.4 million), representing an increase of approximately 10.6% year-on-year. Management plans to build a portfolio of quality commercial investment properties and strengthen its expertise in property management as detailed in its long-term growth strategy of a duo-engine (property development and investment property) business model.

Tactical Arrangements to Streamline the Redevelopment Process

Instead of signing relocation agreements with individual incumbent residents or property owners as most competitors do, LVGEM strategically signs with the cooperatives corporation of the incumbent residents where the rule of voting, by either simple majority or super-majority, could be applied in order to expedite the signing process and limit the ubiquitous issues of ‘nail households’ – people that insist to dwell in the current premises against demolishing for redevelopment.

In addition, LVGEM also uses separate entities owned by its controlling shareholder, father to the chairman and another board member, to conduct the preliminary preparation works that could take up to a decade to transform areas of squatter settlement into lands eligible for redevelopment.

This helps the company avoid carrying long-term contractual liabilities and sizeable non-productive assets on its book, ensuring all the booked land bank will become sellable resources offered for presales within a reasonable amount of time, after fulfilling the regulatory requirements.

Strenuous Municipality Government Approvals Add on Uncertainty

As all redevelopment projects are subject to step-by-step approvals from municipal governments, and the company is required to conduct discussion meeting sessions to present plans in details at an early stage. However, owing to government mandates and regulatory guidance in the redevelopment planning time frame, these steps could take up to a decade.

The initial designs, complementing facilities, and the requirement of a residential-commercial unit mix could vary significantly throughout the process. This adds uncertainties to property developers focusing on redevelopment projects like LVGEM.

In addition, any home purchase moratorium may adversely affect the company's planned presales execution such is the case for the Mangrove Bay No. 1 project. Due to an enacted moratorium on home price, the company had to scrap its presales schedule and even delayed the Mangrove project delivery timeline which resulted in additional costs (i.e. resettlement costs).

We take comfort in the company's competency in dealing with local governments and acquiring the necessary sign-offs given its good track records of delivering multiple projects of the kind, long affinity to local governments as well as the communities, and an international award-winning task force that could swiftly adjust the planned details per request of officials. Also, the high value of these development projects partially offsets the associated financial uncertainties.

According to the management, LVGEM aligns its projects' layouts with local governments' blueprints in locked steps so that its applications often receive welcoming feedback from city offices with expedited approvals.

Exceptional Recognition by Local Government Offices

According to the management, many municipal offices appreciate LVGEM's business know-how and have invited the company to sit on certain commerce committees to share insights of regulation amendments, comment on existing pain points of bureaucratic systems, and facilitate urban renewal initiatives raised by the local governments with their connections in the industry.

We believe the company's niche business model could continue anchoring its handsome profit margin and stable sources of land replenishment providing the impetus for growth.

Sellable Resources Will Rely on Bai Shi Zhou Project Delivery

LVGEM has marked the upcoming Bai Shi Zhou redevelopment as its flagship project. The project's huge total planned GFA of 3.58 million square meters on a canvas of 0.45 million square meters has placed it as the largest redevelopment project the City of Shenzhen has ever seen to date. The site sits in a large traditional low-rise illegal squatter settlement area with about 4,500 households in 1,600 buildings in the city central Nanshan District whose price of land is one of the highest in the GBA.

Upon completion and delivery, all the apartment unit owners will get certificates of property right from the local government which provide strong redevelopment incentives to the incumbent residents. LVGEM does not hold the land right permit to date but we have factored the project into our assessment given the fact that the company has received the preliminary project approval issued by the government in December 2018.

Being an unprecedentedly large redevelopment, the Bai Shi Zhou project is structured financially different from LVGEM's other projects. In general, the controlling shareholder injects a project in full into the listed company which is the legal entity liable to all the contractual obligations to its external parties including the residents' cooperatives corporations. But the listed company so far only owns 25% of the Bai Shi Zhou project and is accordingly responsible for the proportionate liabilities and expenses.

The management intends to acquire the remaining 75% of the project in due course. We see such an arrangement creating a moderate level of uncertainties to the listed company during this transitional period and will revisit the company's profile if any deterioration and/or execution problems shall surface in the process.

Financial Profile

Key Assumptions

- Contracted sales amount: RMB6.0-8.8 billion for 2019-2021
- Contracted average selling price: stable for 2019-2021
- Land acquisition expenditures: 50% of annual contracted sales for 2019-2021

Key Financial Metrics

2017A-2021F	Debt/Land Bank ²	EBITDA/Interest	Debt/Capitalisation	Quick Ratio
Weighted Average	N/A	2.1x	63.5	0.33

Source: LVGEM's 2018-2019 annual and interim reports and Lianhe Global's adjustments and forecasts

Liquidity

As a listed company, LVGEM's board of directors delegate the decision-making authority to the top professional management team. All major financing decisions require unanimous approval.

The company does not use any alternatives financing vehicles. The management matches its foreign currency assets and liabilities, using no derivatives to hedge its open positions. Everbright Bank offered LVGEM's Bai Shi Zhou project a large construction loan of RMB20 billion which has been partly drawn down to pay for the incumbent residents' relocation subsidies and allowances.

² Total debt includes LVGEM's reported interest-bearing debt

Appendix I: LVGEM's Rating Factors

Rating Factors	Weight	Initial Rating
I. Market Demand Analysis	15.0%	a-
II. Business Analysis³	45.0%	bb-
III. Financial Analysis⁴	40.0%	ccc+
IV. Base Score	100.0%	b+
V. Industry Risk		bbb
Base Rating		b+
VI. Qualifiers		
Liquidity		Neutral
Corporate Governance		Neutral
Debt Structure and Financial Policy		Neutral
Idiosyncratic Analysis		+1 notches⁵
Stand-Alone Creditworthiness (SAC)		bb-
VII. External Support		
Corporate Entity Support		Not Applicable
Issuer Credit Rating		BB-

Source: Lianhe Global

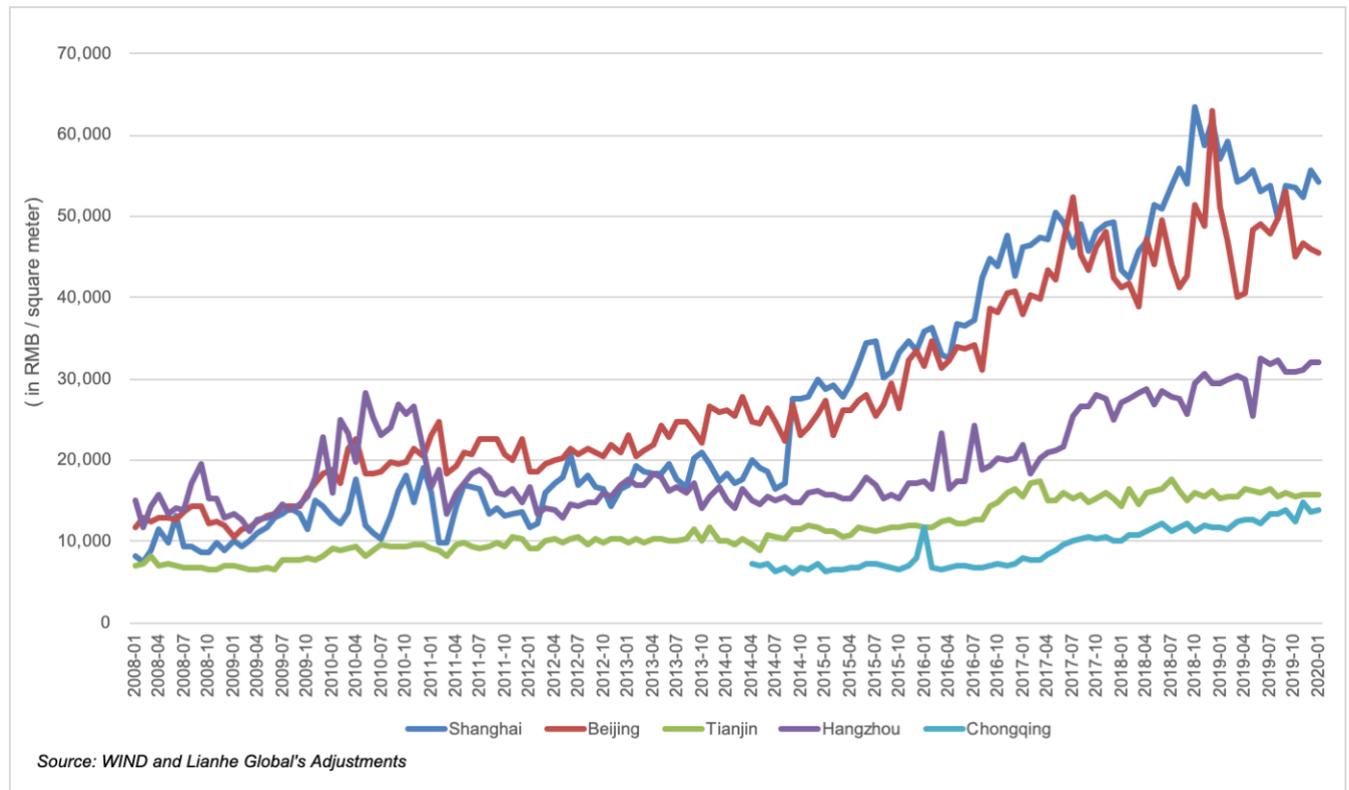
³ Business Analysis contains sub-factors of market position, diversification, competitive position, operating efficiency and profitability.

⁴ Financial Analysis contains sub-factors of debt/land bank, EBITDA interest coverage, debt/capitalization and quick ratio.

⁵ The one-notch idiosyncratic adjustment is mainly due to our considerations of the upcoming Bai Shi Zhou project. Lianhe Global takes a more qualitative approach to examine the creditworthiness of LVGEM from various perspectives, which include but are not limited to strategic execution, managerial quality, historic track record, sustainability, competitive edge, etc.



Appendix II: Major Chinese Cities' Monthly Contracted Average Selling Price



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