JCAP

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China | Real Estate

Guangzhou R&F (2777 HK)

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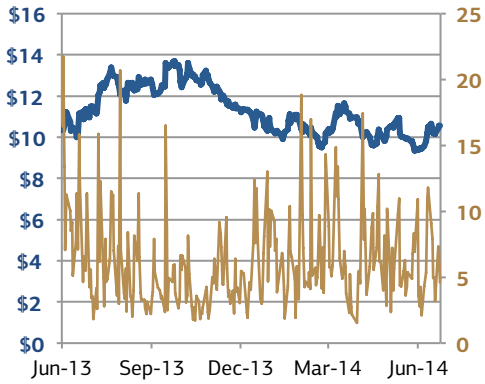
So, you want to book sales?

Guangzhou R&F (2777 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, July 16, 2014

Guangzhou R&F (2777 HK)

Price	HKD 10.56
Rating	**SELL**
Price target	**HKD 4.54**
Difference	**57%**
Market Cap	HKD 34.02 bln
Simple Moving Avg.	6.0 mln
P/E	3.53x

Source: Bloomberg, July 16, 2014

+ Contracted sales growth contrasts with overall market trends

R&F's contracted sales in June draw a sharp contrast to property trends across China—such a contrast that we simply do not believe that the reported sales numbers indicate real and permanent sales. Neither transaction data for the market from the NBS nor our primary checks with R&F sales offices support the company's reported results. We suspect that a related-party sale in Guangzhou generated the good print.

+ Offering discounts, reducing down-payments

Our checks indicate that R&F has started offering high discounts and reduced down-payments, six-month financing for down-payments, or zero down-payments.

+ Swapping properties for advertising

We found that R&F has swapped properties for advertising in Guangzhou Daily. The swap could be in payment of a debt from 2013. It signals a shortage of cash, and suggests one of the ways in which R&F could be inflating its reported sales.

+ Facing cash-flow problems

Our research shows that R&F failed to make full payment for several parcels of land in Guangzhou.

+ Reiterate SELL; maintain PT of HKD 4.54

We reiterate our sell recommendation and maintain our price target at HKD 4.54, applying a 40% discount to NAV based on our assessment of cash-flow challenges and sales that are likely slowing.

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Sales or financing?

Amid a falling market, R&F in June reported phenomenal monthly contracted sales, of RMB 4.0 bln, with total GFA sold of 343,100 sqm, representing YoY increases of 31% and 40%, respectively. YTD June contracted sales grew 39% YoY to RMB 25.8 bln, with YTD total GFA sold of 1.8 mln sqm, up by 10% YoY. This reported performance conflicts both with the declining trend of property transactions in China and with our checks with sales staff on R&F's projects currently being marketed.

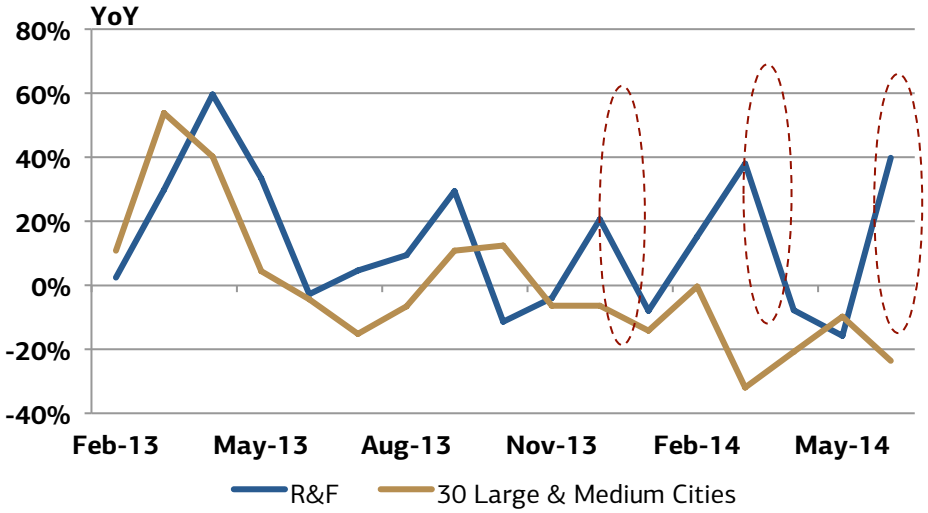
We are very skeptical of R&F's reported contracted sales, which don't line up with any of our checks on the projects.

End-of-quarter effect

We remain skeptical about R&F's double-digit growth in contracted sales. The numbers conflict with already massaged sales data provided by the NBS on total GFA sold in 30 large and medium cities, showing a decline of 23.6% YoY in June and an 18.6% YoY drop on a YTD basis. Sales volume in terms of GFA sold went down by over 20% YoY in June in Tier 1, Tier 2 and Tier 3 cities, where R&F's properties are mainly located.

Our own checks find no market-beating excellence in R&F, and yet R&F has reported strong YoY growth in total GFA sold at the end of each of the last three quarters amid a market that has been declining since 2013 Q4. We suspect R&F has been overstating contracted sales to fit its financial reporting needs and/or meet the performance requirement for its bank loans, as 2014 is the key year for R&F to refinance its borrowings.

Chart 1. R&F vs. 30-city index: GFA sold YoY



Source: Company data, Wind, J Capital Research

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We can't find the growth

We interviewed by phone sales representatives of 38 R&F projects in a general survey of projects on sale nationwide in June. We found the entire market environment for property developers deteriorating.

Our phone interviews with sales representatives indicate worsening or flat sales in R&F projects.

Due to the promotions being offered by R&F and third parties it collaborates with, such as online and offline agencies, the actual ASPs offered by R&F were reported to be decreasing slightly compared with the previous checks conducted in March and May. Sales staff were unwilling to share their exact current sales levels with us, but, this time, only three out of 25 said there was an improvement in monthly sales, while the rest told us that their projects were experiencing flat or declining sales compared with May.

Additionally, we have not found many new projects launched into the market. Three projects, in Meizhou, Xi'an and Najing, originally scheduled to launch in 2014 Q2, have postponed their openings.

Our survey indicates that R&F now allows buyers to delay their down payments. Among the 38 projects, the staff of 21 projects were willing to share the information with us. We were told that 13 projects are now offering zero or reduced down-payments, and buyers are being offered a term of up to six months to pay off their down payments. This contrasts with what we found with our previous checks on sales in March and May, when R&F sales staffs denied any installment plans. Given the R&F in these cases collects no cash, the determination of a sale would likely be discretionary.

R&F has started offering zero or reduced down-payments as well as down-payment financing in several of its projects.

To support issuance of a mortgage, government regulations across China require first-time buyers to pay 30-40% of total price, while second-time buyers are required to pay about 50-60%. In this sense, the installment plans offered by property developers function as financing methods that bypass regulations. The objective for developers is to continue generating contracted sales in a slowing sector. We don't exclude the possibility that developers are faking contracts to get mortgages in order to increase their cash flow.

As we are seeing more contracted sales recognized by R&F, the company should have more receivables on its balance sheet. This would present no problem in a growing property market, but China's is slowing down. If selling prices were to drop significantly, R&F would suffer, as buyers with lower or zero down-payments

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can simply default on payments to avoid any loss on their property values.

Mysterious transaction in Guangzhou

Sales were mainly driven by Guangzhou, which accounted for one-third of R&F's monthly contracted sales in June and 37% of total contracted sales in 2014 H1. Contracted sales in Guangzhou jumped 48% YoY and 169% MoM in June, while other cities, apart from Huizhou, have seen contracting sales decline on a MoM basis.

A mysterious company described as a "partner" of R&F purchased most of the company's Yingyao building in Guangzhou.

In Guangzhou, one particular transaction in March caught our attention. This transaction drove the strong 626% YoY increase of monthly contracted sales, to RMB 5.3 bln in Guangzhou. Our online research, calls with sales staff and onsite visits to the sales offices revealed that one of R&F's "partners" purchased almost all of the developer's Yingyao office building, in a transaction that we estimate was close to RMB 4.0 bln.

R&F's Yingyao office building. Photo by J Capital | July, 2014.

According to the sales staff, that partner was planning to buy only seven floors at the beginning, but suddenly purchased almost the entire building paying a high ASP; thanks to this, R&F cancelled the public launch of this project. However, after going through all the filings, performing several online searches, and talking with sales

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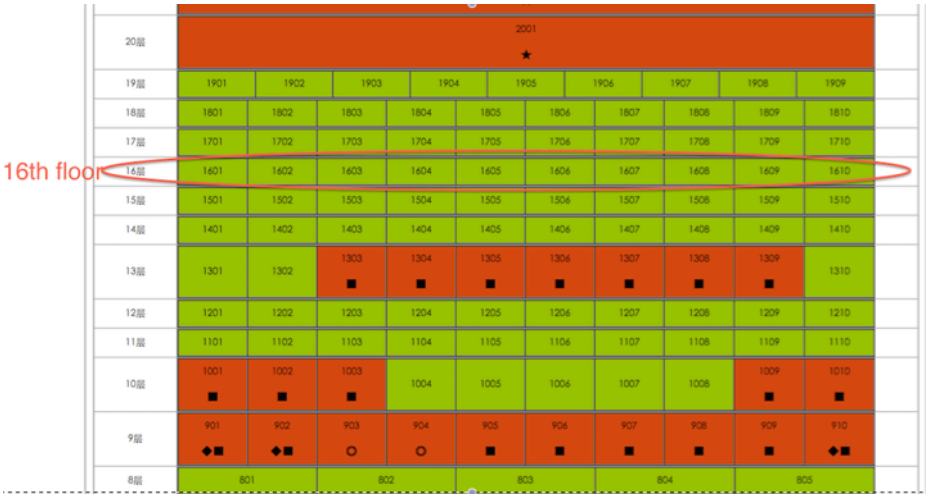
staff, we could not find any information on R&F's partner

Property in exchange for expenses

We learnt from domestic filings that, at end of April, Guangzhou R&F signed a deal with Guangzhou Daily, offering units of the entire 16th floor of its Guangzhou Yingdong building (or Dongshan New Word), valued at RMB 72 mln, in exchange for cash and advertising in Guangzhou Daily. The Yingdong project was launched at the end of 2013, with an ASP of about RMB 31,000-39,000/sqm, and its delivery is scheduled for December 2015. However, only less than one-third of the office building has been sold so far, according to online statistics provided by the Guangzhou Property Information Center.

R&F is now exchanging units for advertising, in what can be regarded as a signal of its cash flow problems.

We called Guangzhou Daily's IR and they were unwilling to disclose details of this transaction. We don't think Guangzhou Daily will use the property as office space. The reason we believe Guangzhou Daily "bought" Yingdong is because the media company has receivables from R&F for advertising the Yingdong property at the end of 2013. Besides, online statistics also show that properties of Yingdong's 16th floor have not been registered for sales yet, which make us believe Guangzhou Daily may resell those properties for cash in the future.



Floor map of R&F's Yindong's building. Source: http://g4c.laho.gov.cn/

This transaction also indicates that R&F has cash-flow problems in its Yingdong project. Trading properties for expenses is very common in the property sector, and it happens when developers find it hard to sell their projects and don't have enough cash flow to pay suppliers and contractors.

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Unsettled land payment

We believe Guangzhou R&F has serious cash problems. In addition to high leverage, the company seems unable to meet the land payment schedule that it previously agreed to with Guangzhou's local land authorities. According to a news article[1], R&F stands in danger of default on land use rights for over 10 projects, mainly located in the Zhujiang new town area of Guangzhou. For instance, a property owner at R&F's Gold Harbor City project has not been able to obtain the land use rights for the apartment he bought in January 2011 because R&F has not made the full land payment yet.

In addition to continuous high leverage ratio, R&F seems unable to meet the land payment schedule that it previously agreed to with Guangzhou's local land authorities.

Another example of R&F's delay in land payment is the Asian Games City project, which was developed by Guangzhou Lihe, an associate of R&F and other property developers. From R&F's annual report, by the end of 2013, Guangzhou Lihe entered a supplement agreement with authorities to reschedule the outstanding land premium and extend the portion of RMB 3.2 bln out of RMB 10.2 bln, which was supposed to be fully settled in December 2011, to November 2014.

We tried to learn more about land payments R&F acquired in 2013, but local authorities are unwilling to give us any details. Regulations issued by Ministry of Land and Resources require developers to pay 20% of total land value as deposit, pay 50% as installment in one month after they acquire the land and make full payment within one year. But in reality, payment terms are negotiable with local authorities. Because R&F has failed to make land payments in time for several occasions, we are suspecting that its aggressive land acquisitions in 2013—a total GFA of 20.9 mln sqm—was motivated by the use of land as collateral to obtain bank borrowings.

Refinancing risk for the RMB 5.5 bln onshore bond

R&F has over RMB 18.1 bln in borrowings to repay by 2014, including RMB 2.6 bln in offshore senior notes due in April 2014 and a RMB 5.5 bln onshore bond due in October 2014. In addition to the issuance of a USD 1.0 bln offshore bond, which should be sufficient to cover the RMB 2.6 bln senior notes, the company announced in 2013 a plan for onshore corporate bond issuance of no more than RMB 6 bln to refinance its RMB 5.5 bln onshore bond, but this is still awaiting CSRC approval. We question R&F's

[1] http://news.xinhuanet.com/house/xa/2014-04-10/c_1110184250.htm

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ability to successfully raise cash on the domestic bond market.

Although the refinancing risk exists for R&F, we think it's still controllable and the company can resort to more bank loans. But we note that resorting to more banks loans would only increase its credit risk in a slowing property market. Not a good recipe for success.

Valuation

Given our estimate of R&F's potential sales and cash flow problems, we maintain our sell recommendation and price target of HKD 4.54 based on a 40% discount to our estimated NAV of HKD 7.57.

Risks

- Stronger than expected demand for housing.
- Continuous removal of purchase restrictions across China.
- Loosen credit policy for both developers and buyers.

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