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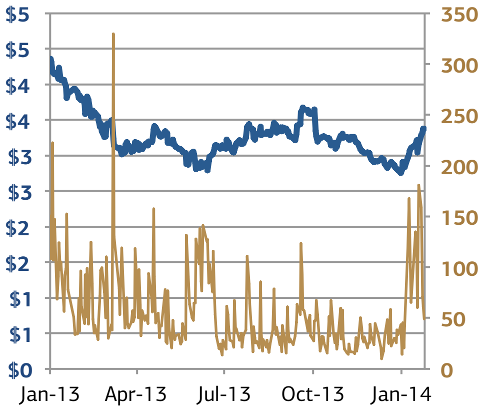
China | Real Estate

Evergrande Real Estate Group Ltd. (3333 HK)

Use of proceeds

Evergrande Real Estate Group Ltd. (3333 HK) one-year share price in HKD (blue) and volume (gold, in mln shares)



Source: Bloomberg, February 14, 2014

Evergrande (3333 HK)

Price	HKD 3.38
Rating	**SELL**
Price target	**HKD 1.09**
Difference	**68%**
Price change since initiation	**+33%**
Market Cap	HKD 54.24 bln
Simple Moving Avg.	94.37 mln
P/E	4.23x

Source: Bloomberg, February 14, 2014

+ January sales phenomenon

On February 11, Evergrande reported that its January sales increased by a phenomenal 52% YoY despite the Spring Festival holiday, with average prices up 25% and contracted sales area increasing 22%. The results were all the more remarkable given that preliminary January data showed China property transactions down by about 16%. We are simply awed by the results, which do not seem to track with primary checks on properties. But Evergrande has sprawling holdings across the country and it is not easy to know how all the properties are doing.

+ Buying into a bank

In January, Evergrande spent a little over RMB 33 bln to purchase just under 5% equity in Huaxia Bank, a Shanghai-listed bank, following as many as 30 other mainland developers. These equity purchases, we think, are to gain access to loans rather than for any strategic, long-term reason.

+ Buying but not retiring

We are curious as to why Evergrande spent HKD 1.7 bln in six days to buy back shares when the company is strapped for cash, with net gearing at about 130% just on the books—not counting off balance sheet obligations that we estimate to be very high. The 562 mln shares of its common stock, have not been retired yet, so the stock appreciation in the last few days is speculative.

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Gambler

Evergrande in January doubled down on risk by using HKD 1.7 bln of its scarce available cash to repurchase about 3.5% of its outstanding equity. The move had some positive effects, as Evergrande's share price rose about 6% over the last week of January even as other Hong Kong-listed developers sagged by about 10% along with the exchange generally. But we expect the run-up to be brief.

We note that Evergrande has not retired the repurchased shares as of February 12. This may be a simple administrative matter but we will be watching the monthly reports to see whether Evergrande might have some use for the shares other than reducing outstanding share count.

Normal companies might pay down some of that 130% of debt. But Evergrande management likes to throw the dice.

Huaxia

Evergrande's purchase of 4.52% equity in A-listed Huaxia Bank brought the company into the swelling ranks of mainland developers that own significant shares in banks. In 2013, Vanke (200002 SZ) bought 8% of Anhui's Huishang Bank, a major lender to another provincially owned company, Anhui Conch as well as to Anhui government platform companies that build real estate and use cement. The alliance could give Huishang a better forward view of cement demand, and it could give Vanke preferential access to loans. Yuexiu Property (0123 HK) has announced it is buying 75% of Chong Hing Bank (1111 HK). Greenland Holding (0337 HK) owns a 4% stake in Shanghai Rural Commercial Bank, 3.8% of Bank of Jinzhou, and, according to the Chinese press, a controlling stake in the Panjin City Commercial Bank in Liaoning.

We believe that the principal reason for these purchases is to secure access to bank credit, which otherwise is restricted to developers. Altogether, according to Chinese reports, roughly 30 developers own pieces of banks in China. Prior to last year, Chinese mining companies were buying into banks. Huainan Mining, for example, invested in China Merchants and controls a small bank called Wuhu Yangzi Bank.

Evergrande displaced Hongta Tobacco as the fifth-largest shareholder of Huaxia.

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Weakening market?

The -77% sales in December were reversed and then some in January.

Official data on January property sales has yet to be released, and press reports are confusing. Some indicate weak sales even compared with the Spring Festival holiday season in 2013. Sales of commercial property in first and second tier cities fell 18% and 21% YoY in November and December respectively, according to NBS data, and early press reports show an accelerating fall in January--but other reports showed high growth for selected companies. Evergrande's recent report shows the company roaring back from its negative 77% YoY growth in December sales. The central bank promised to inject significant new credit into the system in January. Without accelerating credit, China's property markets, we believe, will fall sharply.

Evergrande faces significant calls on its cash resources over the next few months and needs increasing sales to fuel its cash flow. We expect that new loans from Huaxia will be promptly forthcoming to justify the use of capital.

Valuation

We value Evergrande on a NAV basis, reducing asset value by the value of pre-payments and trade payables as well as gross debt. Given that shares have not yet been retired, we have not applied the smaller share count.

Risks

We believe that a portion of Evergrande's results is driven by the availability of credit. We also believe that Chinese authorities will flood the economy with new capital in Q1. This could drive Evergrande shares higher.

The popular craze for real estate investment could continue into 2015 and longer; an end to the current bubble could not occur for a long time or could not occur at all. Evergrande, as a company that positions itself frankly for property speculators, is well positioned as the developer of properties to buy and flip.

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