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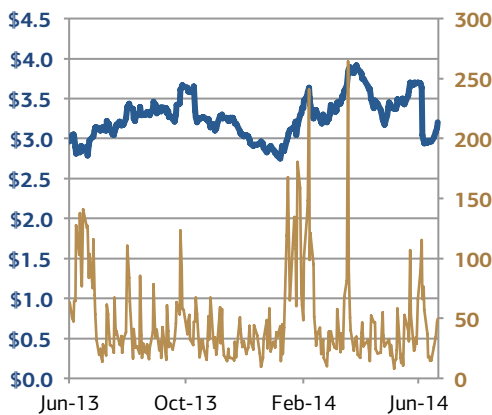
China | Real Estate

Evergrande Real Estate (3333 HK)

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Not making sense

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



Source: Bloomberg, July 7, 2014

Evergrande (3333 HK)

Price	HKD 3.20
Rating	SELL
Price target	HKD 0.48
Difference	85%
Market Cap	HKD 46.8 bln
Simple Moving Avg.	45.9 mln
P/E	3.24x

Source: Bloomberg, July 7, 2014

+ No money down

In interviews of Evergrande's 70 newest projects on sale, we found that 35% offered to finance buyers' down-payments. Discounts offered over the phone by the sales offices ran from 8-20%.

+ Organizing speculator groups

Sales agents working for Evergrande have told us some of their sales are made to buyers in other locations who do not visit the properties. One Evergrande sales office in Chongqing with extraordinarily high sales results was organizing groups of investors to visit the southern city of Fangchenggang to make purchases. We suspect, without having proof, that some of these purchases may be pure financial investments without the actual acquisition of property.

+ Mysterious sales

The 91% growth in contracted sales reported by Evergrande for April is not matched by any interview evidence or the extensive site visits by our staff. No location reported sales growth anywhere near that magnitude, and many reported a contraction in sales volume and higher price discounts.

+ Asking price 10% below reported price

We were able to obtain a full count of units at only 27 of the projects. We took a weighted average of the asking price at those locations and got RMB 5,928 for a month when the company reported an average ASP of RMB 6,333. In April, we estimated RMB 5,937 per sqm, while the company reported RMB 6,980. Our estimated price did not account for the discounts also being offered to buyers, which are a minimum of 5%, leaving a yield for Evergrande that we think is at least 10% lower than reported.

+ PT HKD 0.48; recommendation: SELL

We believe that Evergrande prices will end the year on average 20% lower and that this level of sales makes it impossible for the company to service its debt. On a NAV basis, we estimate that the company is worth HKD 0.48 per share.

All About Finance

In 2014, Evergrande has been consistently reporting phenomenal sales growth that accords neither with market conditions in China nor with the activity plainly visible to visitors to the projects. Our visits to Evergrande projects, on the contrary, show faltering sales and slashed prices, while the company has massive construction and land-development commitments. We believe that an urgent need to fund these commitments may be the key to understanding the gap between reports and visible reality: some of the sales look very much to us like financing schemes rather than irrevocable sales. In some cases, purchases come with guaranteed returns from rental income that is pooled and managed by third parties, but we have not seen occupants at these “rented” locations and suspect that “rental income” is just a legally compliant name for a return on financing.

Co-dependents

Evergrande is increasingly relying on partners to make sales; some of these partnerships look like ponzi schemes.

Evergrande appears to have accelerated its reliance on partners to help make sales. Some of the partners, including SOEs close to Evergrande, simply organize bus tours of the properties and receive a commission, while buyers recruited through these channels receive an extra discount.

But other partners are organizing purchasing groups that look suspiciously like Ponzis. One of those groups is called Tujia. This Beijing-based company acts as a management agent for Evergrande properties in Guangdong, organizing rental income for buyers. Sales agents for Evergrande properties say that Tujia guarantees a return of 7%—and yet the housing units being “rented” have not yet been completed or occupied. A manager at Tujia in Beijing said over the phone that Tujia keeps half the “rental income” as its fee and the buyer keeps the other half. The spokesman also said that Evergrande pays Tujia for this service but he would not disclose any further terms.

At each unfinished Evergrande property we have visited in the past couple of months, existing owners receive incentives to introduce new buyers. When the buyer is making a straightforward purchase of a property and receiving title to it, that incentive makes sense: an introduction from a friend is probably much more effective than an advertisement. But there is evidence that at least some Evergrande properties are being sold as “share interests” to

groups of speculators. The shares represent time-share interests and may be sold to others. This format can easily degenerate into a Ponzi scheme, with the “rental income” for a new shareholder coming from new cash coming in from sales of shares.

We have found this scheme to be more and more common in vacation areas. Developers work with third-party companies to organize buying groups that sell time-share rights to properties. The buying groups often receive “rental income” despite the evident vacancy of the units. In one city, we interviewed a financial guarantor who was organizing such groups, in two others, a rental agent and an online real estate listings company.



Evergrande Springs Metropolis in Enping, Guangdong. Above: the sales office. Below: villas under construction. Planned for the site are an exhibition center, a “food street” with food from eight countries and a hotel. There will be 16,785 housing units. The greater Enping region has a population of only a few thousand. The city of Jiangmen is about three hours away by car and Foshan about two hours. Photos by J Capital | June 2014.

Half of the prospective buyers coming to visit two Evergrande luxury projects in Guangdong, Hawaii on the Sea and the Enping Spring Metropolis, are recruited by travel agencies that partner with Evergrande, according to sales agents. Another 20% are from large local SOEs, and another 20% from other types of cooperators—companies like Soufun. The big SOEs bus in 40-50 people at a time; reports differ greatly on how many make a purchase.

Recognizing a sale

Contrary to the evidence of eyes and ears for anyone who visits any Evergrande property in China, the company has reported sales growth of 64% year to date, a downturn in reported results for May notwithstanding.

Some one-quarter of the Evergrande projects we interviewed say that they offer zero or reduced down-payments, providing financing to buyers and in some cases simply forgiving a portion of the 30% down-payment. At all the new projects now being marketed, buyers may purchase on installment plans rather than applying for mortgages. Installment plans are a common tactic used by developers when mortgages are hard to obtain, but they present a problem: government regulations do not permit transfer of a title before the unit has been paid in full (whether by a bank or by the owner).

Given that buyers are not receiving the right to use “their” homes until payments have been fully made, and, given that some purchases are made without any down-payment, how does Evergrande recognize a sale? If a sale is deemed to have been made without cash and without transfer of title, then sales volumes would be awfully easy to determine at discretion. And, buyers could change their minds or could default on payments; in that case, a sale might be precariously similar to a loan.

This brings us back to the massive buybacks carried on Evergrande’s balance sheet. In the 2013 Interim (and not again), Evergrande disclosed RMB 68 bln in buy-back commitments. We suspect that some of those buy-backs represent repayment commitments to Chinese financial institutions that lend money to Evergrande against collateralized housing units. In other words, Evergrande could be recognizing sales that really are loan receipts, and the company could have an obligation to repurchase those units. This strategy is fairly common among Chinese developers as

We suspect a portion of Evergrande’s RMB 68 bln in buybacks are repayment commitments to Chinese financial institutions.

a means of managing cash flow in a tight lending environment.

Evergrande claims that the buy-backs are guarantees to homebuyers during the 18 months or so it may take to process transfer of title:

As at 30 June 2013, the Group arranged bank financing for some property buyers and provided a buy-back guarantee in relation to the repayment obligations of approximately RMB 68 billion for those buyers.¹

Given that the RMB 68 bln is roughly equivalent to the company's total gross revenue for the previous 12 months, the guarantees cannot have been in support of retail purchases unless there were no mortgages issued and no down-payments made.

Indeed, at Evergrande Hawaii on the Sea, buyers on installment plans are given the option of paying RMB 10,000-20,000 to an intermediary company in return for a certificate from the tax office "proving" ownership of the housing unit. This option is provided to buyers who do not yet have title or the right to use their purchased units, according to a Beijing-based agency that cooperates with Evergrande.

Our survey vs. their reports

In May, we called 135 Evergrande projects that are currently being sold in China, or about half the total of active Evergrande projects. We had brief conversations with sales agents at 70 of the projects on sale.

Our survey on Evergrande projects indicate that its ASP per sqm in May was about 21% lower than what the company reported.

Evergrande's published ASP for May was RMB 6,333/sqm, down by 11.6% YoY, but, prior to discounts, our calls found an average price per square meter of RMB 5,928. Additionally, every complex we spoke with offered published discounts of between 8-20%. Additional discounts are available for buyers who pay in cash, for purchases of multiple units, through "gifted" floor area, zero-interest financing, and other schemes. We believe that a minimum of 5% off is standard. That means that the May ASP per sqm should have been RMB 5,632, not RMB 6.333. That price would have been 21% below the reported May 2013 average price, a drop that accords with discounts we are seeing at other developers.

¹ Evergrande 2013 Interim Report page 11

Our calls in April found the same discrepancy.

Among the projects, 32, over half of the 60 projects that responded to the question, offered no down-payment or down-payments of 6-8% rather than the required 30%. The other projects declined to answer the question or did not know the answer. The majority said that sales had improved a bit month-on-month but deteriorated year-on-year. The Huafu project in Dongguan, Guangdong was offering discounts for bulk purchases of a minimum of five units.

In fact, we believe our estimate that Evergrande prices are 10% lower than stated is generous. Evidence at many projects indicates a company desperate for cash. Hawaii on the Sea is selling for roughly one-third of the price being asked at a Poly project down the road, with no appreciable quality difference.

Valuation

We looked at the break-up value of Evergrande's three major segments, Property Development, Investment Property, and Other (including Management Services) and calculated a total enterprise value of roughly RMB 100 bln. Netting out over RMB 89 bln in debt—and we believe undisclosed debt is higher—plus various minority interests, we arrive at an NAV under HKD 1.

We believe that Evergrande's land and property assets have some recovery value and could conceivably be acquired at a deep discount by another developer. But we believe that Evergrande cannot afford now to complete properties that have already been pre-sold.

Risks

The Chinese government is engaged in putting significant stimulus into the market, and that could revive buyer confidence and in turn, the prices of Evergrande projects. Should Evergrande be able to raise prices by about 20% from what we believe is the current average, the company could salvage its equity value.

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