

JPM-pp1

Asia Pacific Equity Research

16 March 2015

Evergrande Real Estate (3333 HK)

Neutral

Price: HK\$3.39

13 Mar 2015

Price Target: HK\$2.55

PT End Date: 31 Dec 2015

Dissection of positive 2014 profit alert

Evergrande issued a positive profit alert on March 13, 2015. In the announcement, the company said it expects 2014 net profit to increase in the range of 25% to 35% Y/Y, due mainly to (1) increase in delivery; and (2) increase in gains of investments in PRC securities. We do not think this is a positive share price driver as the gain is mainly from the non-core business, and such profit growth should exclude the distribution to PCS. We remain cautious on the stock and think the stock looks expensive at the current 8.3x 2015E core P/E.

Sources of the “positive alert”

- **Core net profit from recurring business should still be down Y/Y:** From “net profit” to “net profit attributable to shareholders”, we need to adjust for (1) minority interest and (2) distribution to holders of perpetual capital instruments; then from “net profit attributable to shareholders” to “recurring core net profit”, we need to adjust for (1) gains/loss from non-core businesses (e.g. unrealized gain on investments in securities) and (2) revaluation gain. After removing these, we expect Evergrande’s core net profit from recurring business to be at Rmb7.28 bn, down 18% Y/Y from Rmb8.86 bn in 2013.
- **Big perpetual capital instruments distribution:** Evergrande had Rmb25.0 bn perpetual capital securities (PCS) as of end-2013, and Rmb44.5 bn as of Jun-2014. Assuming an annual rate of 11% p.a., this should incur at least Rmb3.82 bn distribution to PCS holders in 2014, without factoring in any payment for PCS raised in 2H2014. This is the main reason for the decrease in core net profit in 2014, in our view.
- **Gain in Huaxia Bank A-share investment:** On January 24, 2014, Evergrande announced it had acquired 402.7 mn shares in Huaxia Bank, at Rmb3.3 bn. The stock price of Huaxia Bank (600015.SS) rose from Rmb8.57 per share to Rmb13.46 per share in 2014. This implies a Rmb1.97 bn unrealized gain in financial assets in 2014, and should be the main gain in PRC securities as per the announcement. We do not think this should be included in the calculation in the core net profit of the company as such a gain is not recurring and is rather opportunistic.

Potential risks on the stock

- **Aggressive revaluation gain may not be realizable:** Evergrande has been aggressive in revaluing its investment properties (unsold retail, car parks, etc). In 2013, the post-tax revaluation gain was Rmb3.36 bn and in 1H2014 the revaluation gain is already Rmb3.31 bn. We expect Evergrande to continue with its aggressive revaluation approach and could record a gain of at least Rmb1 bn in 2H2014. This would result in a ~30% Y/Y gain in revaluation gain. However, according to *Sohu* and *focus.cn*, Evergrande has launched a national campaign to sell-off its retail and car parks at a 45% discount, starting March-2015. This could potentially result in a loss when such properties are realized in the P&L in future years.
- **Aggressive dividend payout should continue:** Evergrande has a dividend policy to distribute 50% of the reported net profit. If this still holds, this should result in Rmb6.4 bn dividend payment in 2014, or about HK\$0.65 per share (19% implied yield). Even at a 30% payout ratio, which is our base case, this would imply HK\$0.39 DPS (11% implied yield). We do not think the company will change its aggressive dividend policy, despite the stressed balance sheet.

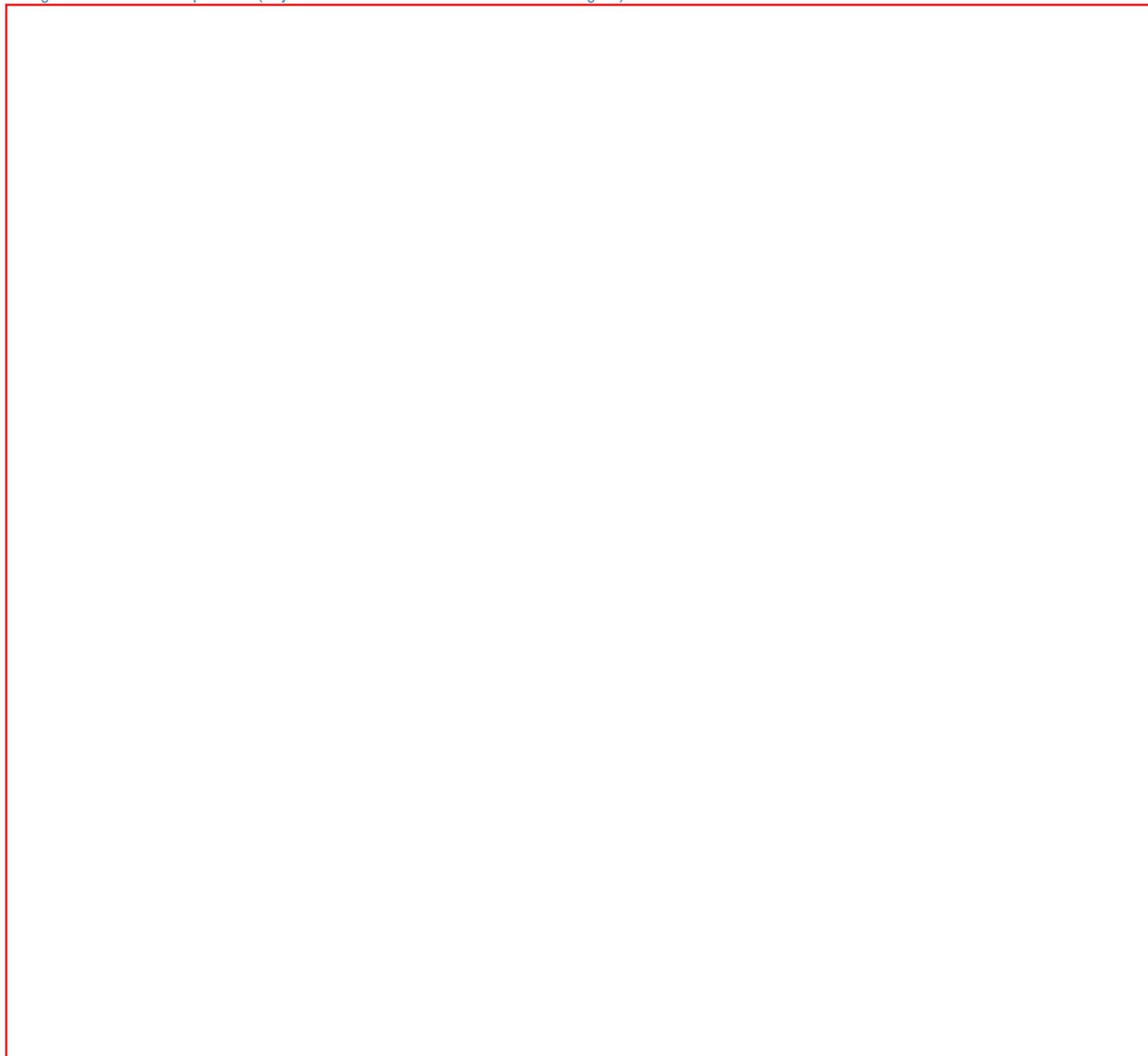
JPM View

- **Remain cautious:** We remain cautious on Evergrande, and think the valuation looks expensive. Our Dec-2015 PT of HK\$2.5 is based on 5.5X 2015E P/E, which is at the low-end among mid-cap developers due to its high gearing. We do not think Evergrande’s business model is sustainable due to (1) deteriorating margin on the back of increasing price-cap

housing; (2) high interest payments with a very leveraged balance sheet (at 286% net gearing by our estimate). Evergrande has slowed down landbanking in the primary market, and if such a trend is the same for its secondary market acquisition, the company is likely to see a slowdown in contracted sales beyond 2015. This would result in an earnings decline and weaken the debt servicing ability of the company.

2014 result preview

[Evergrande 2014E result preview \(adjusted for Huaxia Bank mark-to-market gain\)](#)



Sources: J.P. Morgan estimates

Investment Thesis

We are still cautious on Evergrande and maintain our Neutral rating. While we expect the football team disposal to generate an exceptional gain and give a price tag to that business, bottled water is still loss-making, and the investment in new agricultural businesses and solar business have become new concerns. The share buyback may provide share price support near-term and this is key reason why the stock is not an Underweight today.

Valuation

Our Dec-15 PT of HK\$2.55 is based on a 5.5x 2015E P/E. Our target multiple is among the lowest in the sector, given the corporate governance risk and high gearing.

Risks to Rating and Price Target

Key downside risks to our PT include an entry into more loss-making businesses, a deterioration of the operating environment in the water businesses, a slowdown in sales in lower-tier cities, delivery slippages due to low lock-in ratios, and potential cost overruns due to a lack of experience in tier 1 cities. Key upside risks include a sudden increase in demand in low-tier cities, loosening credit that brings down funding costs, and better-than-expected operation in the water business.

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Date	Rating	Share Price (HK\$)	Price Target (HK\$)
24-Feb-11	OW	3.51	5.80
30-Mar-11	OW	4.00	6.10
31-Aug-11	OW	4.62	6.50
25-Oct-11	OW	2.88	4.95
23-Feb-12	OW	4.67	5.90
29-Mar-12	OW	4.22	5.70
29-Aug-12	OW	3.19	3.90
30-Nov-12	OW	3.79	4.25
17-Jan-13	OW	4.65	5.30
27-Mar-13	OW	3.49	4.25
22-Jul-13	OW	3.11	3.60
27-Aug-13	OW	3.30	3.75
27-Nov-13	N	3.25	3.40
01-Apr-14	N	3.66	3.25
22-Jun-14	N	2.95	2.70
31-Jul-14	N	3.34	3.30
05-Sep-14	N	3.34	2.75
30-Oct-14	N	2.98	2.55

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