JPM-pp1

Asia Pacific Equity Research

20 March 2015

Shui On Land Ltd (272 HK)

Neutral

Price: HK$1.73

19 Mar 2015

Price Target: HK$1.90

PT End Date: 31 Dec 2015

Sale of core asset is a good start

Shui On Land (SOL) has set an aggressive sales target of Rmb18 bn in 2015, up 86% Y/Y, with ~45/55 split between residential/ commercial. The company has also become more open in choosing what to sell, and is trying to put a Shanghai office on the market. We think this is the right move. Given SOL's heavy interest burden, we believe it needs to decrease the debt level or it might risk seeing a potential decrease in equity soon. Such disposals can also increase asset turnover and help narrow the discount to NAV, and is positive for the stock if it materializes, in our view. SOL is now trading at 69% discount to NAV, at 1 std dev below the historical average, and we expect the discount to narrow half-way through to average at ~60% by 3Q and 4Q this year, and eventually hit back average when it resumes profitability from 2016. While the story is there, the timing of the asset sale is uncertain, and **we might turn more positive when there is more certainty about the potential disposal**. Stay Neutral at Dec-2015 PT of HK$1.90, which is based on 65% discount to NAV.

- **Aggressive sales target is dependent on en-bloc sales:** SOL's 2015 sales target of Rmb18 bn is not as aggressive as it looks, as more than half will come from en-bloc sales. The Corporate Avenue 1 itself is already worth Rmb5.8 bn, by our estimates. SOL plans to launch new phases at Shanghai Xintiandi (Rmb4-5 bn sellable), Shanghai RHXC (Rmb4-5 bn sellable), plus other stocks in Chongqing, Wuhan and Foshan (Rmb4-5 bn sellable), hence the Rmb8 bn residential sales implies around 60-65% sell-through rate, which is not demanding for projects in good locations at the right pricing. Although SOL is not profitable, its product and brand is still good in China.

- **The worst cash flow situation should be over:** SOL's main problem is that it has spent too much in relocation in Shanghai that generates no profit until cleared (Rmb19 bn as of Dec-2014). This has resulted in a heavy debt burden (Rmb54 bn total debt/perp), and the company has spent two years serving the debt holders, and paying the Rmb4.2 bn interest/distribution to bond/perp holders. With relocation cost to be paid expected to be lower, residential sales should pick up in 2H2015; and for commercial asset sale, we believe the debt level for SOL should have peaked in 2014 and should improve in 2015.

- **How much does Shui On Land need to sell?** SOL has a total debt plus perpetual of Rmb54 bn as of end-2014, of which Rmb5.1 bn is an early drawdown for the repayment in Jan/Feb 2015, hence the real debt burden should be Rmb49 bn, with about Rmb4 bn annual interest payment. We estimate SOL needs to reduce the interest payment to <Rmb2 bn (~2011's level), or about Rmb20 bn decrease in debt, in order to go back on track for a sustainable and profitable business model. This should also restore SOL's net margin to the 12% to 14% level.

- **Asking price appears stretched for Shanghai office asset:** SOL's Chairman Vincent Lo said the company has hired an agent to help coordinate the sales of Corporate Avenue 1 (CA). According to Bloomberg, the asking price for CA is Rmb90K psm, or about Rmb7.5 bn. This price would imply about 3.6% passing yield, versus 5.3% used at SOL's book. The yield is also much slightly higher than the transacted yield in the market (JLL: effective passing yield in Puxi ~6.1-6.3%). As CA is a rather matured asset without much growth potential, we think the asking price is quite high and the asset sales will be slow.

Results briefing takeaway

Key takeaways from Shui On Land analyst briefing as per below:

Operations

• **2014 final dividend** was HK$0.04 per share, plus interim dividend of HK$0.022 per share, which implies FY14 dividend yield of 3.4% with closing price as of end-2014.

• **Less GFA delivery:** Though recognized property sales increased 2% Y/Y to Rmb13.5 bn in 2014, the total GFA delivery was down 14% Y/Y to 552K sqm.

• **2015 sales:** Target Rmb18 bn in 2015, of which, sales from office sales will account for Rmb10 bn and residential property sales will account for Rmb 8bn. Management explained the weak contracted sales of Rmb9.8 bn in 2014, down 41% Y/Y, were mainly due to the less properties available for sale in Shanghai and weaker demand in some tier-2/3 cities.

• **Saleable resources:** The Company will prepare saleable resources of Rmb15-17bn with saleable area 680k sqm in 2015 for residential sales target of Rmb8bn, implying sell-through rate of ~50%. The launch pipeline will mainly be scheduled in 2H2015. Shanghai TPQ (Lot 116) and Shanghai RHXC (Residential Phase 6 - Lot 9) will provide saleable GFA of 45k sqm and 86k sqm respectively in 2015.

• **IP disposal:** Rmb4.9 bn property sales were from disposal of investment properties, disposal of equity holding commercial properties and turnover of associates. The company has also assigned Standard Chartered as the coordinator in charge of its IP disposal.

• **Relocation process:** Management guided there will be faster relocation and sales process in Shanghai TPQ & RHXC in 2015 and it can provide strong saleable resources in Shanghai from 2H2015 to 2017. 100% of relocation has been completed for RHXC Lot 3, RHXC Lot 9, RHXC Lot 2, and TPQ Lot 116, which accommodate total GFA of 361k sqm. Shui On expects the average relocation cost will be about Rmb19,700 psm for RHXC and Rmb48,000 psm for TPQ Lot 116.

• **Investment property:** Rental income was Rmb1.3 bn in 2014, up 11% Y/Y. Management is confident about the sustainable growth for rental income.

• **CXTD business:** Shui On has prepared for CXTD's IPO and may continue to co-develop and invest in projects with CXTD in the future. Some updates are as below

(1) Portfolio: Total leasable GFA of 537k sqm as of end-2014; 157k sqm newly completed in 2014 and expect full completion of the portfolio in 2015.

(2) Occupancy rate: Shanghai TPQ's average occupancy rate was 98% in 2014, compared to 95% in 2013. Rental income growth was Rmb784 mn in 2014, up 3% Y/Y.

(3) Hotel at THE HUB was sold to Great Eagle at Rmb965 mn in 2014 and planned to deliver in 2015.

(4) AEI: Starting Asset enhancement initiatives for Xintiandi Style, which resulted in 19% rental growth, 23% rental reversion, and 41% increase in traffic flow.

(5) Asset management service: portfolio with total GFA of 1mn sqm under management.

Financials

• **Average cost of debt** was 7.1% in 2014, compared to 6.9% in 2013.

• **Net gearing:** 126% as of end-2014 (adjusted for perpetual securities). Increasing gearing ratio was mainly due to the relocation investment and less cash collected from weak property sales in 2014.

• **Debt profile:** Offshore borrowing accounted for 51% of total borrowing.

• **Cash flow** for 2014 and management 2015 budgeted cash flow:

Table **1: Shui On Land – Key cash flow items**

Rmb bn	2014	2015E
Construction cost	5.8	6.0
Land premium	1.5	0.5
Relocation cost	7.7	4.0
Interest expenses	3.5	3.5
SG&A	1.5	1.5
Tax paymenys	2.0	2.0
Dividends	0.5	0.5
Cash outflow	**22.5**	**18.0**
Cash receipt from property sales	7.0	15.0
Other income	1.7	1.9
Cash inflow	**8.7**	**16.9**
Surplus/(shortfall)	**(13.8)**	**(1.1)**

Source: Company data, J.P. Morgan estimates.

Table **2: Shui On Land – 2014 final result summary**

	1H2014	2H2014E	% H/H	% Y/Y	2014	JPM 2014E	% Y/Y	vs JPM
Property sales	4,705.8	4,334.4	-8%	-25%	9,040.2	5,883.3	2%	54%
Rental income	636.0	687.8	8%	14%	1,323.8	1,434.6	11%	-8%
Property management	13.8	14.8	8%	27%	28.6	27.8	8%	3%
Hotel and others	185.2	267.7	45%	45%	452.9	442.4	35%	2%
Gross Revenue	**5,540.7**	**5,304.8**	**-4%**	**-19%**	**10,845.5**	**7,788.2**	**4%**	**39%**

Selling and marketing expenses	(103.0)	(150.0)	46%	-19%	(253.0)	(393.6)	-23%	-36%
Administrative expenses	(543.0)	(438.0)	-19%	-18%	(981.0)	(984.9)	5%	0%
Total SG&A	**(646.0)**	**(588.0)**	**-9%**	**-18%**	**(1,234.0)**	**(1,378.5)**	**-3%**	**-10%**
Property sales	972.0	1,317.0	35%	-26%	2,289.0	1,563.1	-9%	46%
Rental Income	307.0	347.0	13%	-13%	654.0	735.8	-9%	-11%
Others	19.0	13.0	-32%	30%	32.0	59.4	256%	-46%
Unallocated expenses	(242.0)	(225.0)	-7%	3%	(467.0)	(372.0)	26%	26%
EBIT	**1,056.0**	**1,452.0**	**38%**	**-26%**	**2,508.0**	**1,986.3**	**-13%**	**26%**
Interest expenses	(282.0)	(547.0)	94%	7%	(829.0)	(408.3)	2%	103%
Operating profit	**911.0**	**1,076.0**	**18%**	**-32%**	**1,987.0**	**1,830.9**	**-13%**	**9%**
Share of associates/ JCEs	(90.0)	0.0	-100%	-100%	(90.0)	67.1	-58%	-234%
Profit before Tax	**821.0**	**1,076.0**	**31%**	**-22%**	**1,897.0**	**1,898.0**	**-9%**	**0%**
LAT	(273.0)	(553.0)	103%	41%	(826.0)	(123.9)	29%	567%
Income Tax	(249.3)	(113.3)	-55%	-77%	(362.5)	(549.3)	-49%	-34%
Minority interest	(61.0)	(111.0)	82%	-27%	(172.0)	(190.6)	-35%	-10%
Perpetual securities Div	(247.0)	(288.0)	NM	NM	(535.0)	(313.9)	NM	NM
Core net profit	**(9.3)**	**10.8**	**-216%**	**-94%**	**1.5**	**720.4**	**-99%**	**-100%**
Revaluation gain/ (loss) - after tax	935.3	1,215.0	30%	-10%	2,150.3	935.3	-3%	130%
Exceptional items	(129.0)	(245.0)	90%	NM	(374.0)	0.0	NM	NM
Reported net profit	**797.0**	**980.8**	**23%**	**-9%**	**1,777.8**	**1,655.7**	**-16%**	**7%**
Total DPS (HK$ per share)	0.022	0.040	82%	0%	0.062	0.047	0%	31%
Reported EPS (Rmb)	0.100	0.121	21%	-16%	0.222	0.207	-22%	7%
Core EPS (Rmb)	(0.001)	0.001	**-214%**	**-94%**	0.000	0.090	**-99%**	**NM**
Margins								
Pre-LAT development margin	25.1%	0.0%	-25.1%	-27.2%	29.0%	32.6%	2.9%	-3.6%
Post-LAT development margin	19.3%	-12.8%	**-32.1%**	**-33.1%**	19.9%	30.5%	**1.0%**	**-10.6%**
EBIT margin	19.1%	27.4%	8.3%	-2.5%	23.1%	25.5%	-4.5%	-2.4%
Operating margin	16.4%	20.3%	3.8%	-3.7%	18.3%	23.5%	-3.7%	-5.2%
Net Margin (before MI)	2.6%	2.3%	**-0.3%**	**-5.8%**	2.4%	10.8%	**-3.7%**	**-8.4%**
S&G % sales	-11.7%	-11.1%	0.6%	-0.2%	-11.4%	-17.7%	0.8%	6.3%
Effective tax rate	-30.4%	-10.5%	19.8%	25.3%	-19.1%	-28.9%	14.7%	9.8%
Financial								
Net debt / (cash) (incl perp)	40,093.0	47,742.0	19.1%	44.7%	47,742.0	31,540.9	44.7%	51.4%
Shareholders' equity	36,676.0	37,811.0	3.1%	4.6%	37,811.0	37,516.6	4.6%	0.8%
Net debt to equity	**109.3%**	**126.3%**	**16.9%**	**35.0%**	**126.3%**	**84.1%**	**35.0%**	**42.2%**
Contracted sales (Rmb mn) - Incl JCE	2,819	6,931	146%	-32%	9,750	8,337	-41%	17%
Contracted sales (sqm)	131,400	331,800	153%	-13%	463,200	326,220	-25%	42%
Average Selling Price (Rmb psm)	**21,454**	**20,889**	**-3%**	**-22%**	**21,049**	**25,556**	**-21%**	**-18%**

Source: Company data, J.P. Morgan estimates.

Table **3: Shui On Land – detailed net asset value estimate**

Source: Bloomberg, Company data, J.P. Morgan estimates.

Figure **1: Shui On Land – discount to NAV time series**

Source: Bloomberg, Company data, J.P. Morgan estimates.

Investment Thesis

While the recent share placement to Brookfield has improved the capital structure, we think the key solution to Shui On Land's dilemma is to speed up sales for existing projects and en-bloc sales. In order to turn more positive on the stock, we would need to see more improvement in the underlying operation, which is the property sales business, and also the divestment to go through. We now use a 65% discount to NAV as the basis for our PT.

Valuation

Our Dec-15 PT of HK$1.90 is based on a 65% discount to NAV, which is slightly wider than the historical average due to slow sales, high gearing, and a non sustainable business model.

Risks to Rating and Price Target

Key upside risks include faster-than-expected relocation progress, significant improvement in operating cost control and a reduction in interest expenses. Key downside risks include weaker-than-expected contract sales, completion slippage, and a lack of en-bloc commercial property disposal.

China / Hong Kong Property

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Date	Rating	Share Price (HK$)	Price Target (HK $)
19-Sep-07	OW	7.36	12.00
25-Nov-07	OW	8.18	14.00
04-Feb-08	OW	7.66	13.00
18-Apr-08	OW	6.51	10.50
28-Jul-08	OW	6.41	8.70
25-Aug-08	OW	5.40	8.90
27-Mar-09	OW	2.17	3.00
17-Apr-09	N	3.02	3.60
16-Jun-09	OW	4.97	6.60
28-Aug-09	OW	4.49	5.90
28-May-10	N	3.36	3.80
20-Aug-10	N	3.40	3.80
05-Oct-10	N	3.80	4.10
11-Nov-10	N	4.25	4.60
18-Aug-11	N	3.10	4.00
12-Sep-11	N	2.65	3.90
25-Oct-11	N	2.14	3.10
23-Feb-12	OW	3.26	4.00
24-Aug-12	OW	3.03	3.60
14-Jan-13	OW	3.71	4.20
02-Apr-13	N	2.91	2.75
22-Jul-13	N	2.24	2.40
27-Nov-13	N	2.47	2.50
30-Oct-14	N	1.73	1.90

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