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Press Release: Fitch Revises Evergrande's Outlook to Positive; Affirms at 'B+'

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The following is a press release from
Fitch Ratings:

Fitch Ratings-Hong Kong-02 May 2018: Fitch Ratings has revised the Outlook on China Evergrande Group to Positive from Stable, and affirmed the Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'B+'. Evergrande's senior unsecured rating and the rating on all its outstanding senior notes are affirmed at 'B-', with a Recovery Rating of 'RR6'. A full list of rating actions is at the end of this rating action commentary.

The Outlook revision reflects our expectation that Evergrande's leverage, measured by net debt/adjusted inventory, can be sustained below 50%, after falling to 49.6% at end-2017 from 63.3% in 2016, if management follows through with its commitment to lower the company's gearing. Its leverage headroom is very small and we think it is premature to upgrade Evergrande's ratings until we see more sustained deleveraging. The sharp decline in Evergrande's leverage was mainly due to the one-off CNY130 billion in new equity raised by its homebuilding subsidiary, Hengda Real Estate Group Co., Ltd. (Hengda), in 2017, of which CNY117 billion was received in 2017.

We believe Evergrande's improving credit profile is also reflected in the continued reduction of the payable-to-gross inventory ratio to 0.38x in 2017 from 0.46x in 2016. Evergrande's ratings had been constrained to the 'B' rating category by its aggressive financial policy as its business profile is more commensurate with that of 'BB' rating category peers.

KEY RATING DRIVERS

Financial Profile Improvement: Fitch estimates that Evergrande's 2017 leverage would have been closer to 62% without the CNY130 billion raised by Hengda. Of more significance is Hengda's sharp increase in EBITDA margin to 30.4%, helped by higher selling prices from 2016. Evergrande's improved profitability can be supported until 2020 just based on its large land bank of almost 156 million sq m at end-2015, which would fully enjoy the higher selling prices. The company's sustained significant reduction of its payable ratio since it plateaued at 0.5x and above between 2012 and 2015 is another credit improvement.

We think the payable-to-inventory ratio can be sustained at 2017's level of 0.38x while the company is still deleveraging, assuming Evergrande only replenishes land it sold.

Deleveraging Objective: Evergrande had in its 2017 results announcement said it will "further reduce its net gearing ratio in 2018" and "will systematically plan its business development for the year through prudent land acquisitions, emphasis on promoting sales and controlling costs and expenses". Its stated 2018 contracted sales target of CNY550 billion can potentially allow it to cut this year's land acquisition by more than half of the 126 million sq m in gross floor area (GFA) of new land reserves it acquired in 2017. Fitch will assess Evergrande's deleveraging plan in conjunction with its trade payable changes to ensure that the company is not placing more reliance on its contractors and suppliers to extend more credit to help it deleverage.

Sizeable Low-Cost Land Bank: Evergrande's land bank is well diversified and distributed in accordance with economic development potential. We estimate that its 312 million sq m land bank can generate a conservative CNY2,925 billion in contracted sales. Its widespread diversification is shown by 15 of China's faster developing provinces plus Chongqing municipality (out of 31) accounting for 80% of its total contracted sales, which we expect to continue.

Evergrande's large proportion of active projects also demonstrates its land bank robustness. Evergrande had 656 projects for sale, 628 under construction and 498 projects going through delivery in 2017, out of its 766 projects at end-2017. Evergrande's average land cost of CNY1,711 per sq m is low compared with the average selling price (ASP) of CNY9,960 per sq m it achieved in 2017 and CNY10,233 in 1Q18.

Minorities Leakage Impact Contained: The dilution of Evergrande's stake in Hengda to 63.5% in 2017 from 100% has resulted in increased subordination of the parent's creditors. Fitch believes this impact is not yet significant as Evergrande's leverage, based on proportionately consolidating Hengda, is only 3% higher than that of the consolidated leverage. The presence of minorities also means that Evergrande's attributable scale is reduced. The risk of material subordination at Evergrande may surface when Hengda has a significantly lower leverage than that of the consolidated profile. The high level of debt concentrated at Evergrande ex-Hengda may reflect Evergrande's inability to strengthen its financial profile through improved performance at Hengda and this will indicate weak control over Hengda and therefore show weak parent-subsidiary linkage between the two.

Shareholder Friendly Measures: Evergrande bought back its shares totalling HKD6.3 billion (CNY5.6 billion) in 2017. It also plans to declare a high dividend of 50% of distributable profit since 2016 following the completion of the restructuring of Hengda. These measures will exhaust liquidity at the holding company level and weaken its debt-servicing capacity.

DERIVATION SUMMARY

Evergrande's business profile is more comparable with 'BB' category peers as Evergrande has a diversified footprint across the country and products. This offsets its very aggressive financial profile, which is in the weak 'B' category.

Its peers like Country Garden Holdings Co. Ltd. (BBB-/Stable), Greenland Holding Group Company Limited (BB-/Negative) and Sunac China Holdings Limited (BB-/Negative) are operating with similar aggressiveness in their scale expansion and are of similar size except for Sunac, which is growing very rapidly to match these peers.

Country Garden's leverage of around 30% and churn rate of over 1.5x are commensurate with an investment-grade profile and explains the multiple-notch rating difference with Evergrande. Greenland's leverage is higher than Evergrande's but Greenland has a large level of uncollected sales and a lower payable to offset its high leverage. Greenland as a state-owned enterprise has a strong position in acquiring land at low costs especially for new city districts that local governments are keen to develop. We expect Sunac's leverage to fall below 50% in 2018 and it does not have high payables risks, unlike Evergrande.

KEY ASSUMPTIONS

Fitch's Key Assumptions Within Our Rating Case for the Issuer

- - low single-digit total growth in land bank over the next three years

- - ASP to increase in 2018 but moderate to 2017 level by 2020; GFA growth to range between 5% and 10% to get single-digit contracted sales growth from 2019.

- - land cost to increase by 5% per annum resulting in falling EBITDA margin towards 25%

- - dividend payout ratio of 30% following the 50% special dividend to be declared after completion of Hengda restructuring

Recovery Rating Assumptions:

- - Evergrande will be liquidated in a bankruptcy because it is an asset-trading company

- - 10% administrative claims

- - The liquidation estimate reflects Fitch's view of the value of inventory and other assets that can be realised and distributed to creditors

- - Evergrande's current tax payables net of tax assets will be the most senior claim over its lenders

- - We applied a haircut of 30% on its receivables, and 50% on its investment properties

- - We applied a higher haircut of 40% on adjusted inventory despite Evergrande's high margin, which would otherwise support a lower 25% to 30% discount rate, because we believe there will be a leakage of its recoverable value to its very high level of trade creditors

We estimate the recovery rate of the offshore senior unsecured debt at 0%, which corresponds to a Recovery Rating of 'RR6'. This is based on our calculation of the adjusted liquidation value (after administrative claims) of 10%, and based on the order of repayment waterfall.

RATING SENSITIVITIES

Developments That May, Individually or Collectively, Lead to Positive Rating Action

- - Net debt/adjusted inventory sustained below 50% (49.6% in 2017)

- - Contracted sales/gross debt sustained above 0.8x (0.7x in 2017)

- Developments That May, Individually or Collectively, Lead to the Outlook Reverting to Stable

- - Failure to achieve the above over the next 12 months

- - Change in management strategy to refocus on aggressive expansion from stated objective to reduce gearing ratio

- - Failure to reduce short-term debt to below 35% of total debt (48% at end-2017)

LIQUIDITY

Liquidity Remains Adequate: Evergrande has maintained a large cash balance totalling CNY288 billion, including CNY136 billion of restricted cash. It has CNY356 billion of debt maturing in 2018 that can be funded by ongoing contracted sales and its existing cash. We expect Evergrande's working capital investment to fall sufficiently to generate positive cash flow from operations (CFO) in 2018 to support debt repayment. The company also issued HKD18 billion in convertible bonds in 1Q18 to improve its liquidity.

FULL LIST OF RATING ACTIONS

China Evergrande Group

- - Long-Term IDR affirmed at 'B+', Outlook revised to Positive from Stable

- - Senior unsecured debt rating affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD598.18 million 6.25% senior notes due 2021 affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD1 billion 8.25% senior notes due 2022 affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD4.68 billion 8.75% senior notes due 2025 affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD1 billion 9.5% senior notes due 2024 affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD500 million 7% senior notes due 2020 affirmed at 'B-', with Recovery Rating of 'RR6'

- - USD1.34 billion 7.5% senior notes due 2023 affirmed at 'B-', with Recovery Rating of 'RR6'

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Summary of Financial Statement Adjustments -

- - CNY3,333 million long-term payables added to debt

- - CNY1,961 million fair-value adjustment added to gross debt

- - CNY12.8 billion guarantees to third parties and joint ventures at end-2017 added to adjusted debt

- - Inventories adjusted to include development-related assets and liabilities

- - Capitalised interest in cost of sales treated as non-operating expenses

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Additional information is available on www.fitchratings.com

Applicable Criteria

- Corporate Rating Criteria (pub. 23 Mar 2018)

- https://www.fitchratings.com/site/re/10023785

- Corporates Notching and Recovery Ratings Criteria (pub. 23 Mar 2018)

- https://www.fitchratings.com/site/re/10024585

- Country-Specific Treatment of Recovery Ratings Criteria (pub. 16 Apr 2018)

- https://www.fitchratings.com/site/re/10026835

- Sector Navigators (pub. 23 Mar 2018)

- https://www.fitchratings.com/site/re/10023790

Additional Disclosures

- Dodd-Frank Rating Information Disclosure Form

- https://www.fitchratings.com/site/dodd-frank-disclosure/10028964

- Solicitation Status

- https://www.fitchratings.com/site/pr/10028964#solicitation

- Endorsement Policy

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2 May 2018 05:38 ET *Fitch Revises Evergrande's Outlook to Positive; Affirms at 'B+'

2 May 2018 06:02 ET *Fitch: Positive Outlook Reflects Expectation That Evergrande's Leverage Can Be Sustained Below 50%

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