17 January, 2017

NEWSLETTER: CHINA EVERGRANDE

Are its Auditors Asleep?

Nigel Stevenson

It's almost impossible for China Evergrande (3333 HK), the world's largest property developer, to make a loss. Properties it can't sell are simply held indefinitely on the balance sheet. Those it classifies as "investment" properties are revalued, with any increase reported immediately as a profit, even though most are empty. Interest costs on its growing mountain of debt can be largely ignored as they are capitalised. But the consequence is that its balance sheet is being swamped with dead assets earning little or no income. We estimate that around a quarter of the properties it has ever completed remain unsold. The scale of overbuilding is confirmed by our site visits: some properties have been abandoned without being completed. None have been written down… ever. We think a realistic assessment of asset values could result in write-downs totalling RMB150bn (US$23bn), wiping out shareholders' equity three times over. In our view, Evergrande is insolvent. Its financials fail to present "a true and fair view". We wonder whether its auditors, PWC, are asleep.

of any non-financial company globally. Its debt continues to grow exponentially: including perpetuals, total debt increased to RMB540bn (US$81bn) at end-1H16, up more than a third in just six months. In its just-published shareholders' circular, the company revealed total borrowings (excluding perpetuals) increased by a further 36% in the five months up to the end of November. We estimate total debt may have reached around RMB700bn (US$100bn) by end-2016, a similar level to Shell, the global oil company. One of the main reasons for the rapid increase in debt is the growth in dead assets, which are now an estimated RMB255bn, roughly a third of total assets excluding cash.

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Rising finance costs including payments on perpetuals are a drag on both earnings and cash flow. Profits have been on a declining trend in recent years. However, the impact on its income statement is limited as Evergrande capitalises almost all its interest costs (apart from perpetual payments). In our view, it capitalises too much interest. We estimate Evergrande would have made a net loss in 2015 and 1H16 on an underlying basis after minorities and perpetual payments without this overcapitalisation. Even with the recent jump in contracted sales, Evergrande is dependent on Ponzi finance: it needs to borrow additional funds just to pay the interest on its existing debt. Current attempts to outgrow its problems will, in our view, only compound them.

We think Evergrande's auditors, PWC, have failed to take a sufficiently robust stance. They have enabled the company to overcapitalise interest and classify commercial premises and car parking spaces as investment properties. They have also allowed it to overvalue those properties and not ensured other

15:03

Click on the image to view some of the 700 images from our recent trips to 40 of Evergrande's property developments.

1. Empty investment properties: RMB69bn write-down

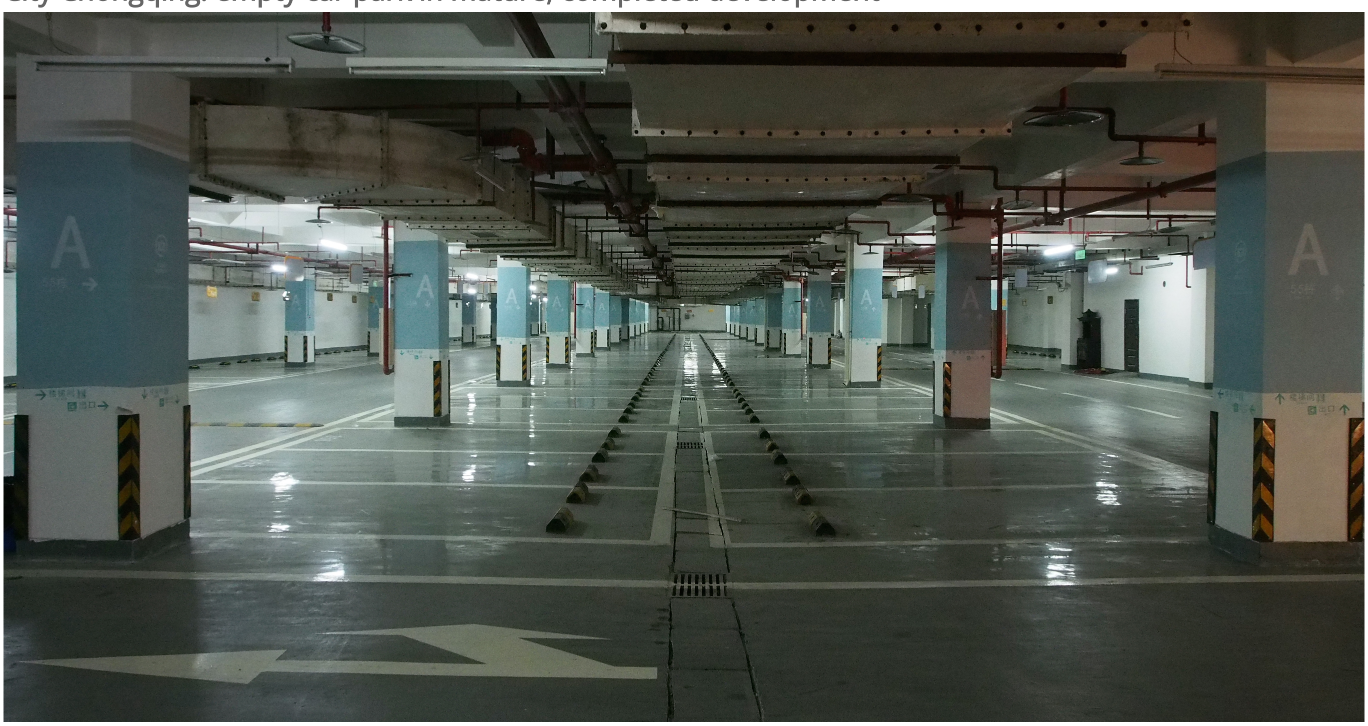
Evergrande's investment properties require the biggest write-downs. These properties more than tripled between 2013 and end-1H16 to RMB122bn (US$18bn), equal to approaching three times shareholders' equity. These are split between 6m sqm of commercial properties (around 60% of the total) and 0.4m car parking spaces (40%), mostly in the company's residential developments. However, these assets generate virtually no income: **the net yield on the completed properties was just 0.4% in 2015, the**

Questionable accounting treatment: Evergrande has persuaded its auditors, PWC, that commercial properties and car parking spaces in its residential developments should be classified as investment properties, rather than inventory. **Evergrande is the only major developer to adopt this treatment**. In our view, Evergrande sells these properties in the ordinary course of business and should, therefore, treat them as inventory. Our site visits confirmed that commercial properties are routinely sold as part of the marketing of new developments.

Dubious valuation: The main benefit of this classification is that investment properties are held at fair value, even before completion. The appraising company, CBRE, predominantly used a “direct comparison” approach rather than the more common “income capitalisation” approach, since there is almost no rental income to capitalise! Evergrande’s car parking spaces are valued at an average of around US$20,000 each and the commercial properties at around RMB12,000/sqm. These valuations lack credibility given that the properties are largely empty and being disposed of so slowly that it would take 50-100 years to clear the backlog at the current rate. **Simply put, Evergrande’s equity base is underpinned by 0.4m largely empty car parking spaces**. We estimate the properties may be worth less than half their current book value, implying a potential write-down of RMB69bn, or RMB54bn net of deferred tax, which is more than Evergrande’s entire shareholders’ equity.

Moral hazard: **The unusual accounting treatment means Evergrande can manufacture profits simply by building more car parking spaces and commercial properties, without needing to sell them**. Moreover, by spreading costs over a larger number of units, it reduces the average unit cost of those properties which are sold, thereby boosting gross margins. It gives Evergrande a strong incentive to overbuild, which is what we found during our site visits on a massive scale.

City Chongqing: empty car park in mature, completed development



Oasis Anshan: endless new empty commercial properties...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SICHUAN TASTE
RESTAURANT

2. Accumulation of unsold properties: RMB21bn write-down

Potential write-downs aren't limited to overvalued investment properties. Unsold completed development properties, which are treated as inventory and held at cost, grew to RMB83bn (US$13bn) at end-1H16, equal to almost twice shareholders' equity. They have increased by more than 50% this year and now represent nearly a year's worth of sales. The recent jump in contracted sales has not put a dent in the backlog. By our calculations, **nearly a fifth of the development properties ever completed by the company remain unsold (around a quarter if investment properties are included)**. Unsold properties are simply parked indefinitely on the balance sheet at cost; none have been written down. We estimate write-downs of RMB21bn are needed, equal to 25% of their value and almost half Evergrande's equity.

3. Excess land reserves: RMB25bn write-down needed

Evergrande has a land bank of 186m sqm, the largest of any developer in China and **enough to house 5m people**. Much of this will probably never be developed given the poor location of many projects. The problem stems from Evergrande's earlier low-cost land strategy, abandoned in 2012, whereby it accumulated substantial land reserves in lower-tier cities and on the edges of second-tier ones. Several projects we visited had clearly failed (for example, Scenic Garden Chengdu, Bay Yingkou), while others were struggling to attract buyers (such as Splendor Laiwu, City Yingkou). Some projects have seen a considerable reduction in their planned size, while others, including the flagship Venice on the Sea development, are progressing so slowly that they will not be finished for many years, if at all. Despite

Bay Yingkou: entire development abandoned, part built

4. Abandoned hotels: RMB20bn write-down

Occupancy at Evergrande's hotels appears low. We visited six out of the ten in operation. Furthermore, other related facilities, including **conference centres and sports centres, were clearly underused and, in some cases, deserted**. We struggle to believe the hotels cover their running costs. **Several more under construction have either been abandoned half built (Scenic Garden Chengdu, Splendor Laiwu) or are progressing at a glacial pace; work on some started up to a decade ago but has still not finished (Splendor Nanjing, Splendor Kunming)**. Evergrande has not written down any of these assets. In our view, they are worth a fraction of their book value. We estimate a potential write-down of RMB20bn, equal to over 40% of shareholders' equity.


恒大酒店
HENGDA HOTEL

5. Overcapitalisation of interest boosted asset value by RMB15bn

Evergrande capitalises virtually all its interest expenses. We estimate around RMB31bn will be capitalised in 2016, more than forecast pre-tax profit. Our calculation of qualifying assets under HKFRS suggests **Evergrande capitalised around RMB6bn too much interest in 2015 and a similar amount in 1H16**. By our reckoning, it would have made a net loss in 2015 and 1H16 on an underlying basis after minorities and perpetual payments without this overcapitalisation. In aggregate, we estimate overcapitalisation has led to the company's asset value being overstated by roughly RMB15bn, almost a third of shareholders' equity. It raises further concerns over the quality of PWC's audit.

6. Insolvent after total write-downs of RMB150bn

Evergrande's balance sheet leverage (assets ex cash/equity) rose to an eye-watering 12x. Our estimated **write-downs of RMB150bn would wipe out the RMB47bn of shareholders' equity almost three times over**. In our view, Evergrande is insolvent as the value of its assets is less than its liabilities. The company's offshore bonds, which are structurally subordinate to its onshore liabilities, are also at risk of being wiped out. The recently announced plan for third party investors to inject RMB30bn into its main onshore holding company, as part of a backdoor mainland listing, may ease short-term liquidity concerns but will not solve Evergrande's underlying problems or affect our overall conclusions.

including perpetual payments on this debt are likely to be around RMB60bn(US$9bn). Evergrande will struggle to finance such a large amount with profits from its development activities, even with the recent jump in contracted sales, which reached RMB373bn in 2016, up 85%. Profits will only be recognised when the properties are completed and handed over to buyers, over the next year or so.

Evergrande has remained afloat only by borrowing ever increasing amounts. In theory, strong contracted sales should result in substantial cash inflows, as buyers typically pay the full purchase price shortly after signing. However, in reality, Evergrande's cash flow has been dire: its free cash outflow was RMB84bn (US$13bn) in 1H16 and a staggering RMB278bn, in aggregate, over the last six and a half years. There are already signs that some funding sources have dried up. Predicting exactly when creditors will turn off the taps is impossible but, at some point, it will become **too big to finance**.

Newsletter

china-evergrande-group

INSIGHTS

18 August, 2020

NEWSLETTER: COMING HOME?

Watch out for the privatisation "squeeze out"

Gillem Tulloch

The proposed Holding Foreign Companies Accountable Act could force hundreds of Chinese companies listed on US exchanges to delist over the next few years. For many large companies, seeking a secondary listing in Hong Kong or the mainland is a sensible insurance policy. However, investors should be wary of companies which decide to privatise and then relist. Our analysis of...

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