China Aoyuan Property Group Ltd.

Decent 1H15 results but leverage expected to remain elevated for FY15

Rating Change - Credit

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U/G CAPG'17 to OW-30%, maintain OW30% on CAPG18/19

We expect CAPG's credit ratings to be stable for the full year, but given the management's growth appetite, we would expect leverage of the company to remain elevated in FY15, the credit ratings should be stable, but upgrade potential is also limited in the near term (see Table 1). We upgrade CAPG'17 from UW30% to OW30%, as we see meaningful call probability in Nov'15, and it offers 8% YTC for just 3.5 months of risk, which offers RV vs other shorter dated callable paper like YUZUHOU'17/SUNAC'17. We maintain OW-30% on CAPG'18/19 which offers ~120bp pick-up over the other high beta B names like TPHL/LOGPH, valuation looks fair given its lower credit rating, but still presents good carry opportunities.

Meaningful call probability of the CAPG'17s?

The CAPG'17s will be callable in Nov'15 at 106.94. Although the cost savings might be very marginal if we assumed they issued another 3-yr bond at yield levels similar to the CAPG'18s (~10.4%) to fully refinance the 17s, but at the same time they have already secured even lower cost funding from the recent domestic bond issuance (5.8% coupon). Assuming all of their outstanding trust loans are repaid in 2H15 (c.RMB1.3bn), CAPG should still have around RMB1bn of proceeds left for calling the bonds, if they wanted to, so the size of incremental bond issuance, if any, should not be too big, and there should still be some cost savings (3-6pts depending on size of new issuance). Taking out the 13.875% coupon bond can also give them more rating headroom from an interest coverage perspective, which could be an added incentive to call.

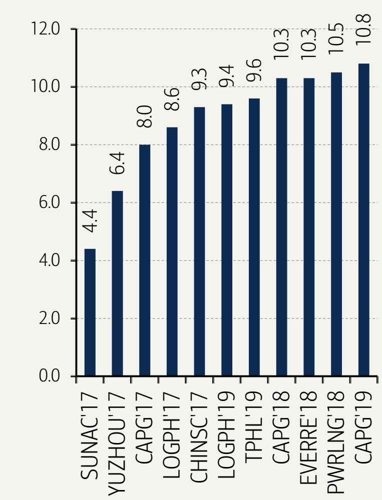
No imminent credit ratings impact on RMB depreciation

Although CAPG has 50% of debt in foreign currencies, impact on RMB depreciation should have manageable impact on the company. Key credit rating threshold set by Moody's/S&P for CAPG is their interest coverage, ratio and CAPG still has ample headroom before it touches the downgrade thresholds (2.2x vs 1.5x trigger for Moody's, and 1.3x vs 1.0x trigger for S&P, using their respective calculation methodologies), CAPG's annualized cash interest for offshore USD/AUD debt is around RMB700m, even with a 10% RMB depreciation, it would only change the interest coverage ratio by less than 0.1x under both calculation methodologies. Furthermore, with the potential of refinancing some of the higher cost debt with the recent domestic bond proceeds, there should be even more headroom going forward.

Decent 1H15 results; watch out for more acquisitions in 2H

CAPG: 1H15 results showed strong YoY earnings growth, but slightly higher net gearing. No major surprises from the results itself. (1) Total debt rose 20% HoH to RMB13.8bn, largely explained by the issuance of US$250m CAPG'18s and the US$100m private bond placement to ABCI. Net debt rose RMB1.5bn or 27% HoH. (2) Cushioned by an 8% equity expansion, net gearing rose 11ppt to 73% while debt/cap rose 3ppt to 59%, still at relatively manageable levels for its rating. (3) EBITDA grew 54% YoY, with strong revenue growth (off a low base) more than compensating for the 1.2ppt gross margin compression. LTM Debt/EBITDA improved from 8.7x to 8.4x. Interest coverage also improved to 1.3x from 1.0x in FY14. (4) liquidity remains adequate with cash/ST debt improving to 1.6x from 1.3x at end-14. (5) CAPG's 1H15 contracted sales grew 18% YoY to RMB6.1bn, representing 45% of full year target. They look on track to meet its full year target of RMB13.5-RMB14bn.

Chart 1: YTW of selected B developer bonds



Source: BofA Merrill Lynch Global Research

Table 1: Credit rating threshold summary

S&P Credit thresholds	EBITDA/Interest	Debt/ EBITDA
1H15	1.3x	8.4x
Upgrade	N/A	5.0x
Downgrade	1.0x	N/A

Moody's credit thresholds	Adjusted EBIT/Interest	Gross margin	Cash/ST debt
1H15	2.2x	29.4%	1.6x
Upgrade	2.5x	N/A	N/A
Downgrade	1.5x	23%-25%	1.0x

Source: S&P, Moody's, Company reportys, BofA Merrill Lynch Global Research

Refer to important disclosures on page 6 to 8. Analyst Certification on page 4.

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Balance sheet

CAPG's total debt rose 20% HoH to RMB13.8bn in 1H15, while net debt rose 27% HoH to RMB7.1bn, cushioned by 8% equity expansion, debt/cap rose 3ppt to 59% while net gearing rose from 62% at end-14 to 73% in 1H15 (1H14: 70%).

The increase in total debt was largely explained by the issuance of the US$250m CAPG'18 at 10.875% and also a US$100m private bond placement to ABCI at 9.25%.

Liquidity remains adequate, with cash/ST debt at 1.6x (FY13: 1.3x), and should have improved further post balance sheet date, after the issuance of the RMB2.4bn 3-year domestic bonds at 5.8%. Pro forma cash/ST debt would improve from 1.6x to 2.2x. Around 80% of the bond proceeds are planned for refinancing some higher cost debt (including onshore trust loans bearing 12-13% rates); hence the year-end gross debt should increase by a lesser amount

At end-Jun'15, debt maturing in two or more years accounted for 52% of total debt (2014: 43%), and trust loans were reduced by RMB350m to RMB1.45bn, and only accounted for 10% of total debt (FY14: 15%), this balance should be reduced further by year end when more of the trust loans are up for repayment.

Management expects total debt would continue to rise, given the intention to further grow its scale, but they have set a cap for net debt/ equity at below 80%, and have so far kept their promise.

Contracted sales and landbank

CAPG achieved RMB6.1bn contracted sales in 1H15, +18% YoY, driven by 54% YoY growth in GFA sold to 0.83mn sqm but offset by 23% YoY decline in ASP to RMB7,322/sqm. The lower ASP was mainly due to sales mix difference, with less commercial/retail properties being sold (32% in 1H15 vs 55% in 1H14).

For 2015, CAPG targets contracted sales growth of 10-15%, i.e. RMB13.4-RMB14bn. This is underpinned by RMB24.5bn of saleable resources, 45% of the full year target was already achieved in 1H15. We think the company looks on track to meet its full year sales target.

During 1H15, CAPG acquired 0.9mn sqm of land for a total consideration of around RMB2bn (attributable RMB1.4bn), representing around 20% of 1H15 contracted sales in value terms.

At end-Jun'15, CAPG had a total landbank of 12.8mn sqm spread across 51 projects in China and Australia. Around 48% of the land bank is located in Guangdong, its home base, and the balance outside of Guangdong. They have 1 project in Australia at the moment.

The company acquired a project in Sydney in March this year for A$120m, and the project is ready for launch soon, with initial subscriptions of A$150m; CAPG also arranged bank loans of A$60m to fund the land purchase, and would draw down more loans according to its construction progress. Typical buyers put down a 10% upfront deposit for their purchases, and will pay the remaining balance upon project delivery in 2-2.5yrs. The cash flow cycle may not be as fast as China projects, but the initial equity investment for CAPG is not high either; management expects 28-29% gross margin for the project, based on the current market price. CAPG formed a 70%/30% with a local partner, which also reduces some execution risk.

Cash flow

CAPG recorded a net cash outflow of ~RMB1.5bn in 1H15, with total cash collection of RMB5.3bn and cash expenses of RMB6.9bn, including RMB3.6bn for construction, RMB1.8bn for land acquisitions (netted-out around RMB0.6bn contributions from JV) and RMB1.5bn in other expenses. Outstanding land premium as of end-Jun'15 stood at RMB1.3bn.

Table 2: CAPG cash flow summary

	1H15	2H15E	2015E	Remarks
Cash receipts	5.3	6.4	11.7	~88% cash collection rate in 1H15
Cash expenses				
Construction	-3.6	-3.3	-6.8	
Land	-1.8	-2.6	-4.4	Net out contributions from JV
Tax	-0.6	-0.7	-1.3	
SG&A	-0.3	-0.4	-0.7	
Interest	-0.5	-0.7	-1.2	
Dividends & others	-0.1	-0.3	-0.4	
Total cash expenses	-6.9	-7.9	-14.8	
Net cash inflow/(outflow)	-1.5	-1.5	-3.1	

Source: Company, BofA Merrill Lynch Global Research

For 2015, company has set a preliminary budget of RMB5bn for land acquisitions, but not all of the proceeds may need to be paid within the 2015, especially if they buy the land in 2H15. Based on our calculations, assuming the company meets their 10-15% sales growth target (RMB13.5-14bn), and achieves around 85-88% cash collection (similar to 1H15), pay RMB4.4bn in land premium this year (RMB5bn net out RMB0.6bn contributions from JV partners for projects acquired in 1H15), there could be a further RMB1.5bn net cash outflow in 2H15. However, if the company refrains from buying any land in 2H15, and just pays off the outstanding land premium of RMB1.3bn, the net cash outflow in 2H15 would only be RMB0.3bn, a very manageable amount. Actual net cash outflow should be somewhere between RMB0.3-RMB1.5bn, in our view.

Net gearing at Jun-15 is actually still lower than most of its peers, and we would not be surprised that CAPG would gear up a bit more in 2H15, given its appetite to grow bigger, but they still have the flexibility of keeping it below their promised 80% level.

Income statement

EBITDA rose 54% YoY in 1H15, with 48% YoY increase in revenue more than offsetting the 1.2ppt decline in gross margin. EBITDA margin actually improved marginally by 0.9ppt to 22.7% as SG&A increased at a slower pace than the revenue growth.

However, given the 20% HoH increase in gross debt level, LTM Debt/EBITDA only improved marginally from 8.7x to 8.4x and interest coverage improved to 1.3x from 1.0x in FY14.

FY14 recognized property sales revenues of RMB6.8bn has yet to fully reflect the 91% YoY increase in contracted sales in 2013 to RMB10bn and the further 22% sales growth to RMB12.2bn in 2014. The company delivered RMB3.9bn revenue in 1H15, with 0.34mn sqm of GFA delivered (+14% YoY); with more GFA delivery expected in 2H15 (1.2-1.4mn sqm for the full year), FY15 EBITDA is expected to grow meaningfully YoY even assuming some margin compression due to higher costs and price discounts and change in sales mix, though the magnitude may not be as strong as what we saw in 1H15; we believe 25%-35% EBITDA growth should be achievable, which should be roughly in-line with their increase in gross debt, hence debt/EBITDA ratios would remain elevated at 8.0x-8.7x, but there should not be any credit rating downgrade pressure. Interest coverage would be at around 1.2x-1.3x. (S&P downgrade threshold 1.0x).

Actually, under Moody's revised methodology, they would add the capitalized interest to their adjusted EBIT. On that basis, adjusted debt/EBIT would have increased improved from 5.2x in FY14 to 4.9x in 1H15 and adjusted EBIT/Interest ratio would have improved from 2.0x in FY14 to 2.2x in 1H15. For the full year FY15 adjusted debt/EBITDA should remain around 4.9x-5.2x and interest coverage would stay around 2.1x-2.2x based on our estimates. For CAPG, the key ratio that Moody's look at is interest coverage, Moody's have set their downgrade threshold at 1.5x and upgrade threshold at 2.5x; CAPG should comfortably maintain its current rating B3 bond rating.

Table 3: CAPG – key financial summary

(RMB mn)

Income Statement (RMB mn)	1H14	1H15	YoY%
Turnover	2,658	3,935	48%
Gross Profit	812	1,156	42%
margin	*30.5%*	*29.4%*	
Selling and marketing costs	(100)	(101)	1%
Admin. Expenses	(143)	(178)	25%
Operating profits	569	877	54%
margin	21%	22%	
Other gains/ (losses)	16	78	385%
Fair value changes on investment properties	18	125	581%
Net financing costs	(35)	(59)	70%
Taxations	(249)	(465)	86%
Minorities	(10)	(17)	65%
Net profit	309	538	74%
EBITDA	580	895	54%
EBITDA margin	*21.8%*	*22.7%*	
Gross interest expenses	583	604	4%
Revenue and contracted sales dynamics	**1H14**	**1H15**	**YoY%**
Property development revenue (RMB bn)	2.6	3.8	49%
Recognized ASP (RMB/sqm)	8,595	11,217	31%
Recognized GFA (mn sqm)	0.30	0.34	14%
Contracted sales (RMB bn)	5.2	6.1	18%
Contracted ASP (RMB/sqm)	9,561	7,311	-24%
GFA sold (mn sqm)	0.5	0.8	54%
Balance sheet (RMB mn) and land bank (mn sqm)	**End-Dec'14**	**End-Jun'15**	**HoH%**
Cash	5,917	6,731	14%
Unrestricted cash	1,989	4,154	109%
Total debt	11,497	13,798	20%
Net debt	5,580	7,067	27%
Short term debt	4,464	4,091	-8%
Total equity (inc. MI)	9,034	9,740	8%
Total debt/cap(%)	56%	59%	5%
Net debt/ equity(%)	62%	73%	11%
Cash/ST debt (x)	1.3x	1.6x	
EBITDA/Interest Expenses	1.0x	1.3x	
Debt/EBITDA	8.7x	8.4x	
Total Land bank (mn sqm)	12.3	12.8x	

Source: Company reports, BofA Merrill Lynch Global Research

Analyst Certification

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China Aoyuan Property Group Ltd. / CAPG

Security	Amt	Maturity date	Ratings Moody's/S&P/Fitch	Next call Call date	Call price	Price	Price date	YTW* (%)	STW (Govt+bps)
11.25, Senior, USD, 2019:B	300	17-JAN-2019	B3/B-/B+	17-Jan-2017	105.63	100.22	12-Aug-2015	11.16	1,001
13.875, Senior, USD, 2017:B	225	23-NOV-2017	B3/N.A./B+	23-Nov-2015	106.94	106.48	12-Aug-2015	10.58	978
10.875, Senior, USD, 2018:B	250	26-MAY-2018	N.A./B-/B+			100.50	12-Aug-2015	10.65	969

Prices are as of date indicated and are from various sources, including BofA Merrill Lynch Global Fixed Income Indices and BofA Merrill Lynch trading desks. CDS spreads are sourced from the Markit Group Limited. Prices are indicative and for information purposes only.

* For loans, YTW reflects yield to maturity.

B=Bond; CS=Capital Security (Not including Equity Preferred); CDS=Credit Default Swap; EP=Equity Preferred

Disclosures

Important Disclosures

Opinion history

China Aoyuan Property Group Ltd. / CAPG

Security	Date^	Action	Recommendation
11.25, Senior, USD, 2019:B	11-Sep-2014	Initial	Overweight-30%
	15-Dec-2014	Downgrade	Underweight-30%
	26-Jan-2015	Upgrade	Overweight-30%
	01-May-2015	Downgrade	Underweight-30%
	05-Jun-2015	Upgrade	Overweight-30%
13.875, Senior, USD, 2017:B	11-Sep-2014	Initial	Overweight-30%
	15-Dec-2014	Downgrade	Underweight-30%
10.875, Senior, USD, 2018:B	05-Jun-2015	Initial	Overweight-30%

Table reflects credit opinion history as of previous business day"s close. ^First date of recommendation within last 12 months.The BofA Merrill Lynch Credit Opinion key is contained below.
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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
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Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

Time horizon – our recommendations have a 3 month trade horizon

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