Sunac China (1918) - Maintain BUY

High financial risk depressing share price

Key Data

Price(30/3/2012)	HK$2.30
Price target	HK$2.95
Upside potential	28.3%
52Wk H/L(HK$)	HK$3.08/1.17
Issued shares(mn)	3,000
Market Cap(HK$mn)	6,900.0
15-day avg vol(mn)	3.6
Auditors	PwC
Major shareholder:	
Sun Hongbin*	51.85%
Bain Capital	10.01%
China Diamond	8.51%

Source: Company data &Bloomberg

**The founder, Chairman and CEO of the group*

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Moderate growth in core profit for FY11: Revenue increased by 59.4%YoY to Rmb10,604mn on the back of 52.3%YoY surge in ASP booked . Net profit increased by 54.6%YoY to Rmb2,383mn with FD EPS up 52.6%YoY at Rmb0.78. Core net profit (excluding revaluation loss of Rmb75.9mn on investment property and Rmb835.4mn gain from re-measurement of previously held interests) was estimated at Rmb1,787mn(or Rmb0.59/share), up 15.8%YoY. A final dividend of Rmb0.0785/share is declared.

Core gross profit margin expanded slightly: The FY11 gross profit margin dropped to 33.6% from 43.3% in FY10. When excluding Rmb1,311.6mn, the amortization of equity interest revaluation gain, FY11 GP margin was at 46.0%. As the 52.3%YoY surge in booked ASP was the major growth driver for FY11 results, the marginally stable GP margin indicated that the quality products or moving to high-end position didn't bring in pricing power to the group. Looking into 2012, we expect the margin trend to be stable as the contracted ASP for 2011(Rmb15,778/sqm) was very close to booked ASP for FY11(Rmb14,112/sqm).

47.4% of FY12 delivery target locked in: As of Dec 2012, we estimate total revenue of properties sold and to be delivered in FY12 was Rmb8.0bn, which represent 44.7% of total forecast revenue for FY12.

Risk factors: High financial risk (net debt/equity at 104.1%), tight cash flow and high funding costs. Actual ASP and valuation of properties deviates from the expected if properties are forced to sell to repay debts.

Results and forecast

	2010A	2011A	2012E	2013E
Revenue(Rmbmn)	6,654	10,604	16,889	25,608
Chg(YoY)	38.8%	59.4%	59.3%	51.6%
Core net profit^ (Rmbmn)	1,542	1,787	2,985	4,871
Chg(YoY)	97.1%	15.8%	67.1%	63.2%
Core EPS (Rmb/share)	0.51	0.59	1.00	1.62
PE(x)	3.63	2.38	1.88	1.15
DPS (HK$)	0.09	0.08	0.08	0.08
Yield	4.6%	4.2%	4.2%	4.2%
NBV/share(Rmb)	1.55	2.35	3.34	4.96
Chg(YoY)	155.2%	51.0%	42.1%	48.7%
PB(x)	1.20	0.79	0.56	0.38
Net debt/equity	31.0%	104.1%	61.0%	30.7%
ROAE	51.1%	40.2%	35.0%	39.2%

^Excluding revaluation G/L on investment property; @Rmb0.8121/HK$
Source: Companies' announcements and ABCI Securities estimates

Earnings Outlook

Expecting contract sales up 17.5%YoY for 2012

The group recorded Rmb17.7bn contracted sales (+148.9%YoY) in 2011 and management are confident to achieve another 25%YoY growth in 2012 sales amount of Rmb22bn.

We are conservatively set the sales target at Rmb20.8bn, up 17.5%YoY and 5.5% lower than the group's budget sales. In our financial model we build in 5%YoY drop in contracted ASP for 2012. In project level, the ASP was down 15-20%YoY respectively, which in line with our previous forecast for the ASP trend in the 1^{st}-2^{nd} tier cities.

Expecting core EPS to surge 67.1%YoY for FY2012

The strong sales growth in 2011-2012 is laying down a solid earnings base for FY12-FY13. We expect the core EPS to grow 67.1%YoY and 63.2%YoY to reach Rmb1.00 and Rmb1.62 respectively in the upcoming two years. The group's ROAE is estimated at 35.0% and 39.2% respectively for FY12-13.

High Financial Risks

Overstretched balance sheets

Net debt/equity ratio jumped to 104.1% at the end of 2011(89.8% as of 1H FY11 and 31.0% at the year of 2010) resulting from land acquisition and equity acquisition of JV partnership. The gearing came sharply above our expectation of 70%.

Tight cash flow

Our funding gap analysis shows that the group could generate positive operating cash flow this year and after repayment of short term debt they still have Rmb3.7bn cash or 17.8% of 2012E sales target for buffer. However, we expect that such buffer can only help it survive and cannot allow it to expand in the market down trend, which the management is targeting.

Rising financing costs

We expect the group to continue to purse high cost funding, such as trust loan and/or JV partnership method to do land acquisition this year as the high gearing and depressed valuation constrain the likelihood of reasonable financing cost through domestic loan, off-shore bond and equity placement. The gross interest expense for FY11 rallied 154.5%YoY to Rmb932mn. The group was suffering from lacking of financial channels and high expenses. We expect the situation to continue into 2012.

2012E funding gap analysis

	2012E Rmbbn
Cash balance in the beginning of year	3.9
Cash inflow from contract sales(80% cash collection ratio assumed for 2011-2012)	18.0
Loan repayment	-2.2
Land premium repayment	0.0
Construction cost payment	-8.0
SG&A+ Financial expense	-2.3
Tax	-3.7
JV partnership investment	-2.0
Buffer before refinancing	3.7 (or 17.8% of expected cash flow from contract sales)

Source: ABCI Securities estimates

Corporate governance issue

Concern on corporate governance

The reported financial statements for FY2011 indicate the financial leverage of the group increased substantially. Net debt/equity ratio surged to 104.1% at the end of 2011 when the government was tightening the monetary policy and implementing various austerity measures to cool down the property market.

The sharp increase in leverage ratio last year reflects the weak corporate governance in financial risk management and aggressive management style in land acquisitions.

Clientele effects on market valuation

The counter (closing price HK$2.30) is at PER of 2.38x and 1.88x for FY2011 and FY2012 respectively. It is at P/B of 0.79x and 0.56x for FY2011 and FY2012 respectively. The counter is at low single digit PER and at deep discount to its NBV. This phenomenon reflects market is very cautious on the business outlook of the group.

After the group reported its audited financial statements for FY2011, we believe most of negative factors (high financial risk, uncertainty of property sales for the rest of the year, tight cash flow, corporate governance, etc) have been considered by the investors and have been factored into the share price subsequently.

The counter is not suitable for prudent investors in view of the group's current financial condition and the current macroeconomic environment.

Valuation

To factor in 1.75mn sq.m attributable GFA acquisition and update development schedule we derived our 2012NAV at Rmb5.17/share for its current 6.55mn sqm. total attributable land reserve.

We switch our valuation methodology to forward PE. On one hand the earnings visibility is improved for the short term while on the other hand we expect the group to further expand land scale this year but the high financial risk will depress its capability to unlock the hidden value in the balance sheet.

We now roll over our target price to June 2012 and TP unchanged at HK$2.95, based on 2.4x FY2012 PE (historical average). Our TP represents 1.0x PB, which is quite defensive in our view. Given a 28.3% upside potential we maintain our BUY rating on the stock. A declining in financial risk in 1H 2012 is a positive factor for its upside valuation.

Disclosures

I, Li Hong-ying, Vivian , being the person primarily responsible for the content of this research report, in whole or in part, hereby certify that all of the views expressed in this report accurately reflect my personal view about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report. I and/or my associates have no financial interests in relation to the listed company (ies) covered in this report, and I and/or my associates do not serve as officer(s) of the listed company (ies) covered in this report.

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