CHINA EVERGRANDE GROUP

Are the Management's Goals Achievable?

APRIL 6, 2020

Management's new goals

Three goals stated by the management

1. Debt reduced by CNY 150bn a year through 2022
2. Land bank reduced to 200mn sqm by 2022
3. Sales increased to CNY 800bn in 2020 and CNY 1tn by 2022

Source: Bloomberg "Evergrande's Aggressive Plan to Reduce Debt Met With Skepticism 2020-04-01"

Characterize the goals in auditable quantities

1. Debt reduction can be quantified as reducing each year CNY 150bn in total outstanding interest-bearing debt through 2022.
2. Land bank can't be quantified and modelled into auditable values such as inventory or revenue. Qualitatively speaking, the goal is to reduce drastically land acquisition amount.
3. Sales could mean contracted amount but not fully recognized as revenue. The company did not specify if it is in cash terms or contract terms. For analysis, we assume that this goal refers to sales only from properties sales comprising of the total cash received from presale, spot sale and after-sale[1] each year.

Summary of the conclusion

The goals to reduce debt AND grow sales are achievable in the short-term if the company can achieve all the followings:

1. Reduce land purchase drastically in 2020 but return in 2021 to the high acquisition level of 2019,
2. drastically increase the sales level by selling nearly all outstanding unsold historical inventory by 2022, and
3. maintain the payables at the current level.

1 For those unfamiliar with Modtris terminology, presale is sale of inventory still under processing, spot-sale is sale of inventory completed in the current year, and after-sale is the sale of inventory completed in the previous years. All sales quantities refer to cash received.

Base scenario – using historical sales rate

Basic model assumptions

- Construction cost is at 75% of land cost and construction time is 2 years
- Payables and loans to related parties are effectively never repaid during the forecasting period
- Payables increase each year by 50% of land purchase amount in the same year
- Loans to related parties increase by CNY 10bn each year if there is enough cash
- No new investment to non-controlling JV or associates
- Debt borrowing is automatically raised if there is any cash shortfall for redeeming maturing debt or completing construction on time. Furthermore, debt redemption shortfall is financed by 1-year debt and construction cost is financed by 2-year debt

Financing assumptions

- **Starting in 2020, target gross new debt per year CNY 225bn, half of the level in 2019.**

Assuming the company keeps the same debt maturities as in 2019, the targeted debt is broken into CNY 122bn of 1-year debt, CNY 65bn of 2-year debt, CNY 10bn of 3-year debt, CNY 10bn of 4-year debt and CNY 22bn of 5-year debt. Keep in mind, these are targets. Modtris model automatically raises the debt to make up any redemption or construction cash shortfalls.

Operating assumptions

- **25% presale at 33% margin, 30% spot sale at 30% margin, 9% after-sale at 0% margin for inventory completed prior to 2019 and at 30% margin for inventory completed in and after 2019.**

Using only the company's past 6-year published balance sheets and income statements, Modtris has computed that historically the company's presale rate is roughly 25%, while spot-sale rate is 30% of the remaining (all sale rates are measured in cash received), yielding 47% cumulative sales of completed inventory in a current year. Furthermore, the company rarely made after-sale of unsold inventory from the previous years. (See details in the article on Evergrande's historical analysis). However, in 2019, Modtris derived from the company's income a CNY 50bn after-sale (roughly 9% of the model-computed remaining inventory) at 0 margin.

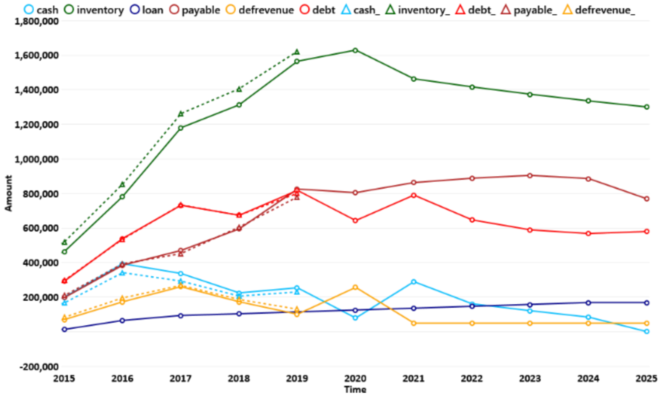
Land acquisition assumptions

- **Starting in 2020, land purchase is CNY 75bn a year.**

By Modtris calculation, this is half of the CNY 150bn level of 2018, and roughly 20% of the CNY 390bn level of 2019

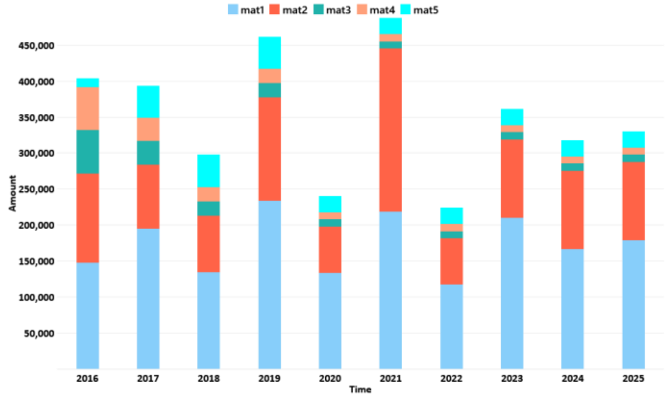
Management's goals are unachievable in the base scenario

Chart 1a. Balance sheet in the base scenario (CNY bn)



Inventory - green, debt – red, payables – maroon, cash – blue, deferred revenue – orange. Dashed lines are reported values.

Chart 1b. Gross new debt in the base scenario (CNY bn)



Blue bars post-2020 longer than the blue bar at 2020 represent the additional funding needed to pay down matured debt.
Red bars post-2020 longer than the red bar at 2020 represents the additional funding needed to complete construction on time.

- CNY 150bn debt is reduced in 2020 (red line in chart 1a), but total debt bounces back to CNY 800bn in 2021 due to the additional funding needed - about CNY 200bn in construction funding and CNY 100bn in debt redemption (see the red and blue bars in chart 1b). Debt is reduced again by CNY 150bn in 2022 but thereafter funding shortfalls for redemption and construction keep the total debt level close to CNY 600bn.
- Note that payables are assumed in the model to increase each year by an amount equal to 50% of the land acquisition spending[2]. It is conceivable that the company may decrease debt by drastically increasing payables, although that would lead to the scenario of payables reaching over CNY 1tn in 2021.

[2] Payables, deferred revenue and debt are the three essential funding sources for Chinese property developers. For these companies, Modtris models payables as debt owed to related parties with long repayment time and undefinable cost. The 50% ratio to land buying spending is based on Modtris' computed historical trend of Evergrande.

Chart 2a. Income in the base case (CNY bn)

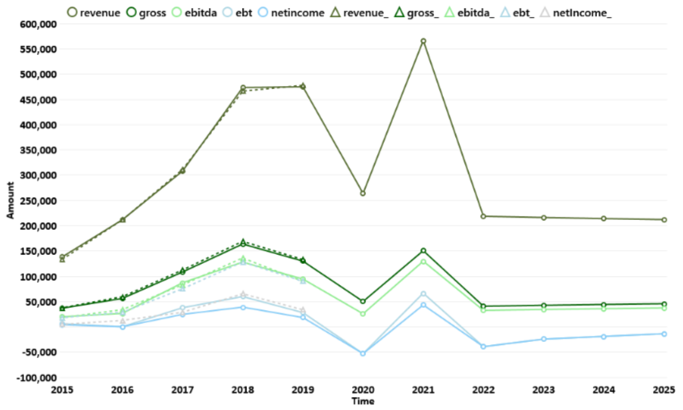
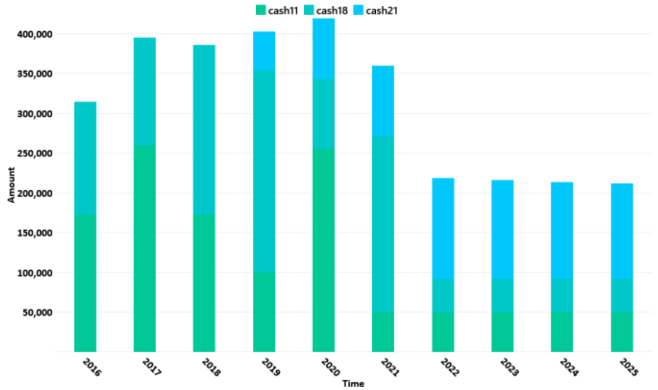


Chart 2b. Cash flow from sales in the base case (CNY bn)



Green – presale. Medium green – spot sale. Blue – after-sale

- The revenue falls almost by half in 2020 due to the halved land acquisition in 2018. But revenue rebounds to CNY 550bn in 2021 due to the raised land purchase in 2019 (chart 2a). Past 2021, revenue falls to CNY 200bn range because of the assumed low land purchase (CNY 75bn each year) in 2020 and onward.
- In terms of cash from sales, total sales is slightly above CNY 400bn in 2020 (CNY 250bn in presale as a result of the rebounded land acquisition in 2019, CNY 100bn in spot-sale and slightly less than CNY 100bn of after-sale), above CNY 350bn in 2021 and CNY 200bn in 2022, well below the sales goal.

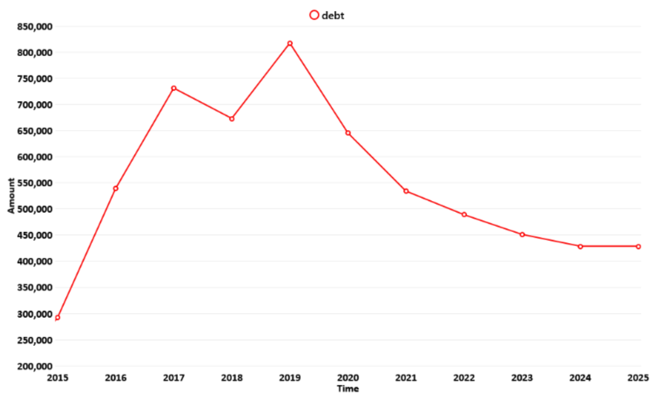
Achievable scenario – goal search the required sales rate

In order to reduce debt beyond 2020, barring drastic increase in payables, the company must raise cash from sales. We project the after-sale levels necessary to achieve the debt reduction goal while assuming that the presale and spot-sale rates and margins are kept as in the base case.

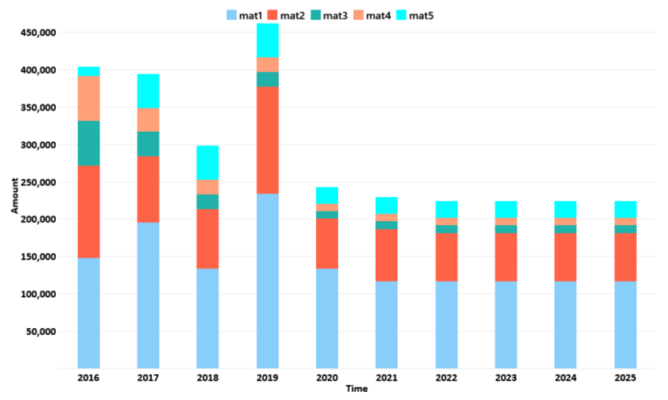
Achievable outcome

Modtris produces a scenario with the following outcomes in terms of debt and sales

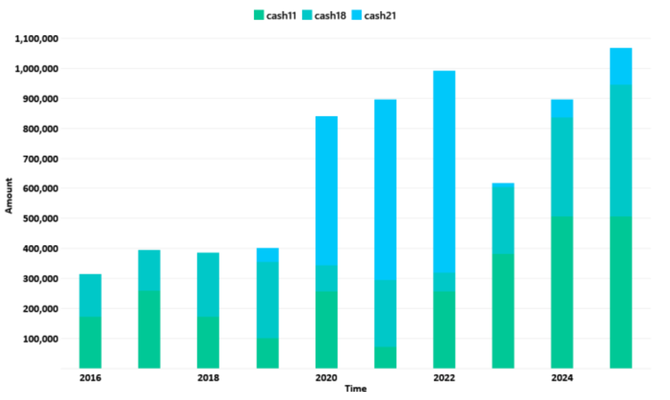
Chart 3a. Debt outstanding (CNY bn)



3b. Annual gross new debt (CNY bn)



3c. Cash from sales (CNY bn)



- Total debt is reduced to CNY 650bn in 2020, to below CNY 550bn in 2021, to CNY 490bn in 2022 and to CNY 450bn in 2023 (chart 3a). Annual gross new debt remains below CNY 250bn and generally at CNY 220bn a year.
- Annual cash flow from sales reaches CNY 800bn in 2020, CNY 900bn in 2021, and CNY 1tn in 2022. Sales after 2022 depend on the after-sale rates and the land acquisition amounts during that period. See chart 3c.

Required conditions in the scenario

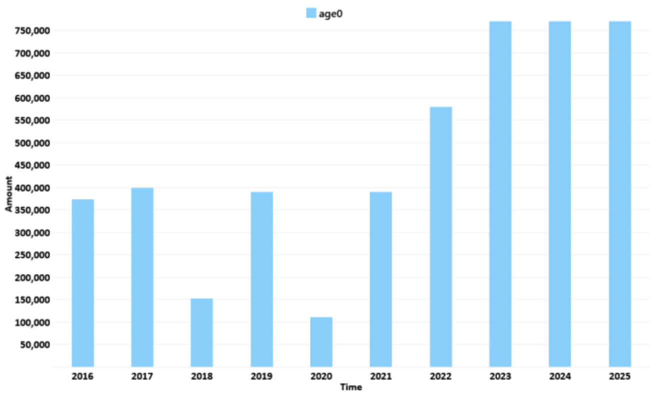
Debt borrowing (chart 3b)

- 2020: gross new debt under CNY 250bn.
- Thereafter: CNY 220bn each year

Land acquisition (chart 4a)

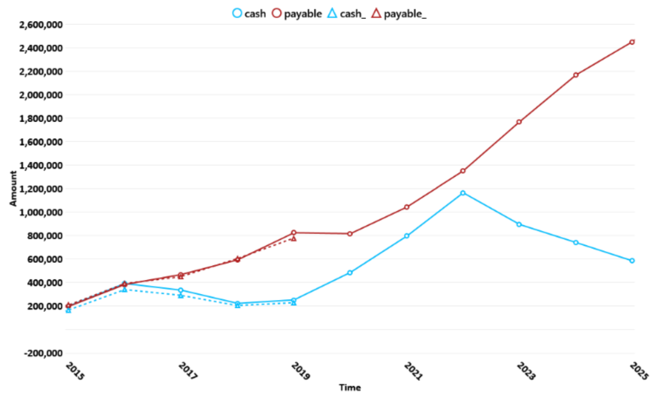
- 2020: Reduce to CNY 100bn. Acquiring too much undermines the debt reduction target and acquiring too little makes sales miss the CNY 1tn goal in 2022
- 2021: Bounce back to CNY 400bn. Any less acquisition undermines the target of CNY 1tn sales in 2022 due to reduced presale
- 2022 onward: Decision depends on what the company's goal is for sales beyond 2022. If the goal is to maintain for the long-term above CNY 1tn and growing sales, and if the company can maintain the base case scenario of sales rates and margins, then land acquisition needs to be maintained at CNY 750bn each year.

Chart 4a. Required land purchase spending (CNY bn)



4b. Projected after-sale rates (ratio)

4c. Payables vs. cash (CNY bn)



After-sales (chart 3c, top blue bars)

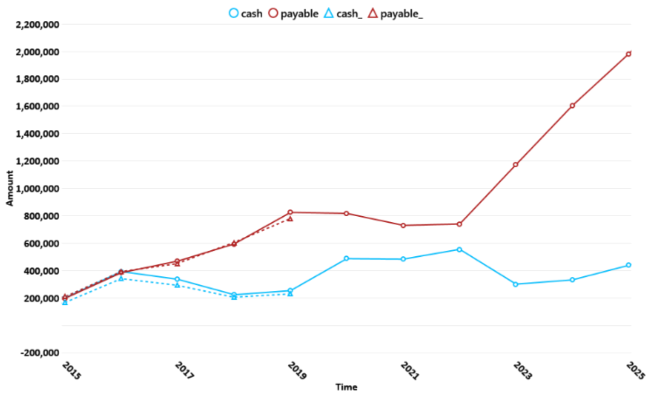
- 2020: Generate CNY 450bn after-sales. This is in addition to the CNY 250bn presale of 2019-acquired land and CNY 100bn spot sale of 2018-acquired land generated from the base case. Modtris computes that CNY 450bn after-sale is equivalent to selling close to 50% of the outstanding unsold inventory completed before 2020 (using margin assumptions as specified before).
- 2021: Generate CNY 600bn after-sale in addition to CNY 300bn presale and spot sale. Modtris computes that CNY 600bn after-sale is equivalent to selling 80% of the remaining unsold inventory completed before 2021.
- 2022: Generate close to CNY 700bn after-sale in addition to CNY 300bn presale and spot sale. Modtris computes that CNY 700bn after-sale is equivalent to selling 100% of the remaining unsold inventory completed before 2022.

- After 2022: We assume that all the sales rates and margins return to those in the base scenario. The company did not specify the sale goals after when CNY 1tn is achieved. If the goal is to maintain CNY 1tn sales in the long-run, then, presale and spot-sale level should double the current level, and after-sale, although initially is small, increases over time as the remaining quantity of unsold inventory increases.

Payables

- Total payables increase above CNY 1tn in 2021 and rise close to CNY 1.5tn in 2022 (see chart 4c the maroon line). However, if the company achieves the sales target, there is excessive cash to reduce the level of payables to below CNY 1tn through 2022 (chart 5a).

Chart 5. Payables maintained under CNY 1tn during 2021 and 2022.



Are these goals sustainable in the long term?

- The reductions in debt and land acquisition can be achieved in the short-term, but in the long-term, the company must grow both again in order to keep the revenue and income growing.
- Modtris projects that in order to achieve the CNY 1tn sales target, the company must grow the land acquisition again in 2021. In the long-term, if the company plans to maintain the high sales level, land acquisition must increase even more to double the current level.
- The company will also likely increase the debt level again after the debt reduction goal is achieved around 2022. Maintaining the low debt level while expanding land purchase, although possible in theory, requires the payables to rise to the levels unlikely to be sustainable in practice (chart 6a). Furthermore, it is needless to keep the debt ratio at an extremely low levels (chart 6c) if the company can grow EBITDA over time.
- See the following supplement scenario for more details

Supplement – long-term scenario of zero debt growth

If the company can

- main new gross debt at CNY 220bn a year (chart 5a),
- increase land purchase to CNY 750 a year in 2022 and keep that level thereafter (chart 5b),
- achieve the sales rates and margins as defined in the base scenario,
- continue the increase of payables per year at 50% of land acquisition spending in the same year,

Chart 5a. Gross new debt each year (CNY bn)

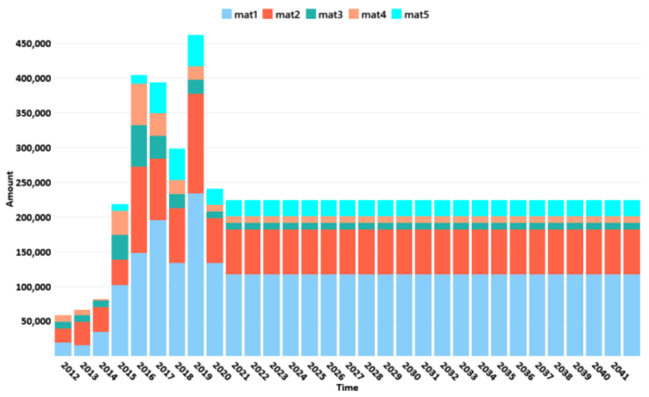
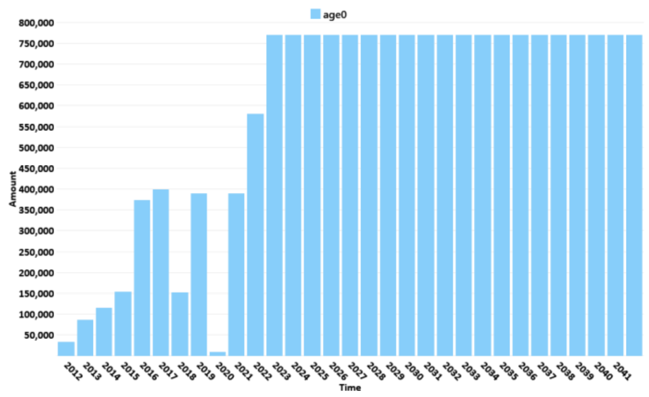


Chart 5b. New land acquisition spending (CNY bn)



then

- total debt can be maintained at CNY 450bn (chart 6a, red line),
- sales can be maintained above CNY 1tn in 2025 and grows higher afterwards (chart 6b),
- debt-to-EBITDA eventually approaches to 1x, and net debt becomes negative in 2021 (chart 6c).

But the challenges are:

- inventory rapidly expands (chart 6a, green line),
- payables continue to increase significantly in place of low debt addition (chart 6a, maroon line),
- increasing amount of after-sale is required over time as the stock of unsold inventory rises (chart 6b, top blue bars),
- tax payables may eventually rise higher than debt (chart 6a, purple line).

Chart 6a. long-term balance sheet

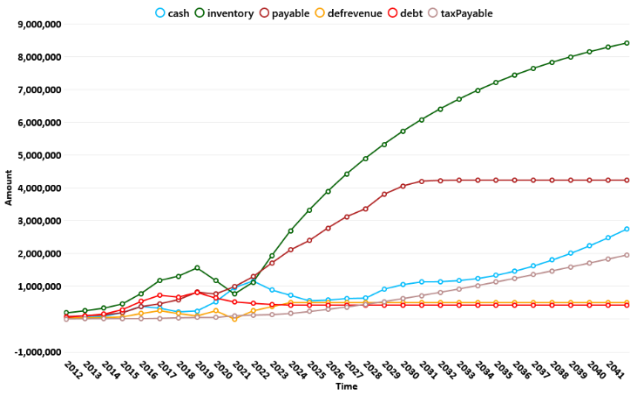


Chart 6b. long-term sales

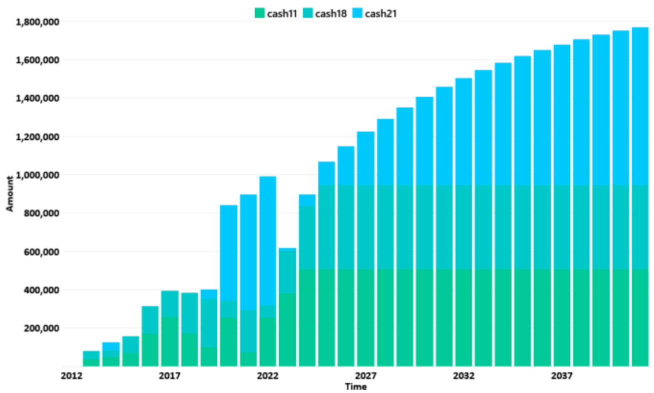
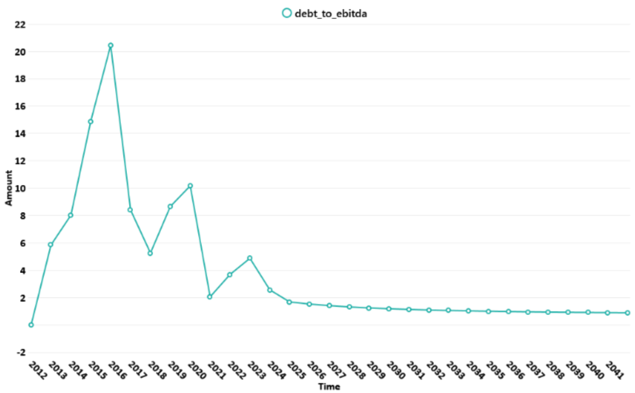


Chart 6c. long-term debt-to-EBITDA ratio



Modtris is a corporate modelling tool that produces integrated projection of a company's entire future financial and physical positions, including all the financial statements such as the balance sheet and the incomes. The main goals of Modtris models are to predict the medium to long-term changes of a company's liquidity and profitability position and to discover the critical factors that affect a company's future.

Modtris models a company holistically as a dynamic system, computing fully the interactions among a company's financing and operating assets and liabilities, and often produces projections that deviate strongly from historical data, offering predictive, rather than extrapolative, insights.

Modtris deploys two steps in making financial projections.

1. Retrofit the model to a company's reported financial statements to derive the historical operating and financing conditions of the company.
2. Compute the future balance sheet and income statements based on the historically derived conditions and the initial financial conditions.

For questions, software download, assistance, and quantitative modelling service, please write to contact@modtris.com