

Jiangsu Zhongnan Construction Group Co., Ltd.

Issuer Rating Report

Summary

| | |
|---------------|-----------------------------|
| Issuer Rating | BB |
| Outlook | Stable |
| Location | China |
| Industry | Homebuilder and Real Estate |
| Date | 26 July 2021 |

Lianhe Ratings Global Limited (“Lianhe Global”) publishes the ‘BB’ global scale Long-term Issuer Credit Rating of Jiangsu Zhongnan Construction Group Co., Ltd.; Outlook is Stable

Summary

The Issuer Rating reflects Jiangsu Zhongnan Construction Group Co., Ltd.’s (“Zhongnan” or “the company”) improved market position and financial leverage. It also considers Zhongnan’s established track record of property development in the Yangtze River Delta (YRD) region, especially Jiangsu province, growing and sizable scale of contracted sales and revenue, and more controlled land acquisitions. However, Zhongnan’s rating is constrained by its land bank exposure to low-tier cities, moderate interest coverage and the lower margin of its construction segment.

The Stable Outlook reflects our expectation that Zhongnan will maintain its market position in Jiangsu province and continue to grow in terms of sales and revenue in a moderate manner, while employing a prudent expansion and land acquisition approach to manage its financial leverage and liquidity position.

Rating Rationale

Sizable and Diversified Land Bank Supports Contracted Sales Growth: Zhongnan had a sizable and diversified land bank portfolio with a total GFA of 44.7 million square meters (sq.m) across 86 cities in China at end-2020. Zhongnan aims to expand its presence to high-tier cities in its land bank portfolio in the long term, but maintains a balanced approach at the same time supported by strong tier 3 cities with quick asset turnover. Zhongnan has deep penetration and brand awareness in the YRD region, particularly Jiangsu province, and gradually expands to central and western China, the Bohai Rim region and the Pearl River Delta region.

Zhongnan’s land bank was primarily located in tier 2 and 3 cities, which accounted for over 95% of its land bank at end-2020. The contribution to land bank from tier 3 cities decreased gradually to c. 59% at end-2020, compared with c. 76% at end-2017. We believe the company is moving towards the direction of enhancing its presence in high-tier cities, although this strategy comes with rising land costs and execution risks.

Zhongnan’s sizable land bank supported its contracted sales growth. The company recorded contracted sales growth of 52.2%, 33.7% and 14.2% in 2018-2020, respectively. Zhongnan’s total contracted sales reached RMB223.8 billion in 2020, which placed it at 17th among Chinese property developers, according to CRIC Information Centre. The company expects to maintain c. 10% growth per annum of total contracted sales in 2021-2023. At end-2020, Zhongnan’s unrecognized sales reached RMB120.3 billion, with most of them can be booked in the next 12 to 24 months.

Zhongnan’s focus on low-tier cities with quick asset turnover to expand and gain market share resulted in low segment gross margins at 17-20% in 2018-2020, which was below industry average level. As Zhongnan gradually moves towards high-tier cities for its

Operating Data:

Jiangsu Zhongnan Construction Group Co., Ltd.

| | 31 Dec 2019 | 31 Dec 2020 |
|---|-------------|-------------|
| Revenue (RMB: in million) | 71,831 | 78,601 |
| Contracted Sales (RMB: in million) | 196,054 | 223,828 |
| Contracted Average Selling Price (RMB/square meter) | 12,723 | 13,281 |
| Contracted Sales GFA (million square meters) | 15.41 | 16.85 |
| Land Bank GFA (million square meters) | 42.26 | 44.72 |

GFA: Gross Floor Area
 Source: Zhongnan

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Applicable Criteria

General Corporate Rating Criteria (16 July 2018)

contracted sales, we expect Zhongnan's property development segment gross margins to maintain at c. 20% in the next 12 to 18 months.

Construction Segment of Lower Margin though Creates Synergies: Zhongnan has an established construction segment which has been granted the highest qualification for general contractor of house building and construction (the only privately-owned enterprise receiving such qualification). Zhongnan's construction business possesses strong technical know-hows and track record across a number of provinces in China. Zhongnan's construction segment is expected to aid its property development segment's expansion, especially outside of Jiangsu province. Given the contracting nature of the construction business, there is considerable working capital requirement. In addition, the construction business commanded lower gross margins of c. 8-12% in 2018-2020. This segment contributed c. 24% of Zhongnan's revenue in 2020. We expect a moderate segment revenue growth in the next 12 to 18 months.

Moderate and Improving Leverage with More Managed Land Acquisition Strategy: Zhongnan's total land bank on hand at end-2020 was sufficient to support its contracted sales for the next two to three years. In order to maintain steady contracted sales growth, we expect Zhongnan to continue replenishing its land bank in a measured manner. Zhongnan spent c. 35% of contracted sales proceeds for land acquisitions in 2020, scaled back from 45-65% in 2017-2018. We expect the company to keep spending 30-35% of contracted sales proceeds for land acquisitions in the next 12 to 18 months.

Zhongnan's reported total debt increased from RMB70.6 billion at end-2019 to RMB79.9 billion at end-2020. Given the larger equity base, Zhongnan's net gearing ratio dropped to 97.3% at end-2020, compared with 168.4% at end-2019. We expect Zhongnan to maintain a moderate debt growth rate. Overall, we forecast Zhongnan's financial leverage as measured by debt/capitalization ratio to further improve to c. 59-63% in the next 12 to 18 months.

Access to Various Financing Channels Despite Exposure to Alternative Financing: Zhongnan has wide access to various financing channels especially in the onshore markets. Exposure to non-traditional banking products, such as trust loans which typically carry higher funding costs, amounted to c. 22% of Zhongnan's total debt at end-2020. The ratio decreased from c. 30% and 27% at end-2018 and end-2019, respectively. We expect Zhongnan to continue lowering this exposure in order to manage its funding cost and debt maturity profile.

Zhongnan's had cash on hand of RMB32.9 billion (including RMB24.4 billion unrestricted) at end-2020 to cover its RMB23.4 billion of debt due within one year. The company also had c. RMB131 billion of approved but unutilized bank line at end-2020. We expect Zhongnan to be able to maintain its liquidity profile in the next 12 to 18 months. Zhongnan is also planning to seek other financing channels such as ABN and ABS to diversify its funding sources.

Rating Sensitivities

We would consider downgrading Zhongnan's rating if it were to (1) aggressively expand and replenish its land bank which results in an increase in its financial leverage as measured by debt/capitalization to over 70% or a decrease in its EBITDA interest coverage to below 1.5x consistently, and/or (2) its operating performance were to deteriorate such that its contracted sales and/or revenue experience a material decline or liquidity profile is worsened.

We would consider upgrading Zhongnan's rating if it were to (1) considerably increase its operating scale while maintaining competitive position in its core markets, and (2) maintain its financial leverage as measured by debt/capitalization at below 60% and EBITDA interest coverage at above 3.0x consistently.

Company Profile

Zhongnan is a Chinese property developer that focuses on mass residential property development and construction in China. Mr. Chen Jinshi, the chairman of Zhongnan, commenced his business and established the predecessor of the company in 1988. Zhongnan focused on construction business at the beginning of foundation. Taking the advantage of the reform in China, the company gradually diversified its business and entered the property development market. Zhongnan is listed on the Shenzhen Stock Exchange (000961.SZ).

Zhongnan is majority owned (53.83%) by 中南城市建设投资有限公司, which in turn is majority held by Mr.Chen Jinshi and his persons acting in concert directly and indirectly through 中南控股集团有限公司。

Exhibit 1: Zhongnan's Shareholding Structure at end-2020



Source: Zhongnan

Business Profile

Zhongnan's main business operation consists of three business lines: (i) sales of properties, (ii) construction, and (iii) hotel and others. Revenue from sales of properties is Zhongnan's major source. Its contribution to total revenue increased to 74.5% in 2020 from 68-72% in 2017-2019. In 2020, revenue derived from sales of properties amounted to RMB 58.6 billion, representing year-on-year increase of 13.5%.

The construction segment is another significant part of Zhongnan's business. It provides synergy benefit and helps Zhongnan offset part of its execution risks. Revenue from the construction segment was RMB19.1 billion in 2020. The construction segment accounted for c. 24.3% of Zhongnan's total revenue in 2020. Revenue from other segments accounted for less than 2% of the total revenue and their contributions to the company were limited when compared with Zhongnan's property development and construction business.

Exhibit 2: Zhongnan's Revenue Breakdown by Business Segment (RMB: in million)

| Revenue/ % of total | FY2017 | % | FY2018 | % | FY2019 | % | FY2020 | % |
|----------------------------|---------------|-------------|---------------|-------------|---------------|-------------|---------------|-------------|
| Sales of properties | 21,375 | 70.0 | 27,560 | 68.7 | 51,587 | 71.8 | 58,570 | 74.5 |
| Construction | 7,241 | 23.7 | 11,660 | 29.1 | 19,063 | 26.6 | 19,082 | 24.3 |
| Hotel and others | 1,936 | 6.3 | 890 | 2.2 | 1,181 | 1.6 | 949 | 1.2 |
| Total | 30,552 | 100 | 40,110 | 100 | 71,831 | 100 | 78,601 | 100 |

Source: Zhongnan's annual reports

Zhongnan's contracted sales reached RMB223.8 billion in 2020, representing a year-on-year increase of 14.2%. Its ranking in terms of contracted sales amount increased to 17th in 2020 from 18th in 2018. Zhongnan's ranking in contracted sales GFA increased to 10th from 15th during the same period.

Exhibit 3: Zhongnan's Rankings by Contracted Sales Among Chinese Property Developers

| Amount / Ranking | FY2018 | | FY2019 | | FY2020 | | Ranking Changes (2020 vs 2018) |
|----------------------------------|--------|------------------|--------|------------------|--------|------------------|-----------------------------------|
| Contracted sales amount (RMB bn) | 146.6 | 18 th | 196.1 | 16 th | 223.8 | 17 th | +1 |
| Contracted sales by GFA (m sq.m) | 11.4 | 15 th | 14.3 | 12 th | 16.9 | 10 th | +5 |

Note: CRIC Information Centre might use adjusted numbers of contracted sales and GFA in the ranking
 Source: Zhongnan's annual reports (Actual amounts), CRIC Information Centre (Ranking)

Exhibit 4: Zhongnan's Rankings by Land Bank Among Chinese Property Developers

| Amount / Ranking | FY2018 | | FY2019 | | FY2020 | |
|--|--------|------------------|--------|------------------|--------|------------------|
| Attributed land bank by value (RMB bn) | 312.6 | 25 th | 396.1 | 20 th | 354.9 | 27 th |
| Land bank by GFA (m sq.m) | 37.5 | 18 th | 53.5 | 11 th | 44.7 | 14 th |
| Newly acquired land bank by value (RMB bn) | 185.4 | 15 th | 150.4 | 20 th | 165.1 | 13 th |
| New land acquisition by GFA (m sq.m) | 15.8 | 12 th | 9.6 | 27 th | 16.2 | 6 th |

Note: The amount is based on statistics from CRIC. Differences may exist between company's reported amount as a different calculation method was applied

Source: CRIC

Zhongnan's land bank GFA increased to 44.7 million sq.m at end-2020. Zhongnan began to actively replenish its land bank and expanded its operation to high-tier cities (such as Tianjin, Wuhan, Hangzhou) since 2016. After Zhongnan's aggressive debt-funded expansion, its land bank is sufficient for development in the next two to three years. Zhongnan's geographical coverage extended to 86 cities, mainly focusing on the YRD region at end-2020. As Zhongnan targeted to expand its footprint to high-tier cities, its average land acquisition cost increased to c. RMB5,002 per sq.m in 2020 from c. RMB4,377 per sq.m in 2018.

Exhibit 5: Zhongnan's Land Bank Composition by Region at end-2020

| Regions/Provinces | Total GFA (in thousand sq.m) | % of total | Cities |
|---------------------------|---------------------------------|--------------|---------------------------|
| Yangtze River Delta | 20,801 | 46.5 | Nantong, Ningbo, Suzhou |
| Bohai Rim | 7,998 | 17.9 | Beijing, Tianjin, Qingdao |
| Central and Western China | 11,176 | 25.0 | Xian, Chongqing, Chengdu |
| Pearl River Delta | 4,752 | 10.6 | Foshan, Huizhou |
| Total | 44,727 | 100.0 | |

Source: Zhongnan and Lianhe Global

Financial Profile

Zhongnan enjoyed rapid contracted sales growth of 52.2%, 33.7% and 14.2% in 2018, 2019 and 2020, respectively, following its strategic expansion since 2016. Per its management guidance, Zhongnan will slow down its pace of growth and target a steady growth for its property development business. Zhongnan expects a c. 10% contracted sales growth per annum in 2021-2023.

We expect Zhongnan to continue to focus on property development business, which will contribute over c. 75% of its total revenue in 2021-2023. At end-2020, Zhongnan had contract liabilities of RMB120.3 billion, which was equivalent to 2.05x of the segment revenue of RMB58.6 billion in 2020. It showed the company has sufficient unrecognized revenue to be booked in the next one to two years. Therefore, we expect the company's segment revenue growth to remain steady in 2021-2023. Overall, we forecast Zhongnan's revenue to maintain c. 10% growth per annum.

Zhongnan's gross margin for property development segment was relatively low but stable at 18-20% in 2018-2020. Given the increasing proportion of tier 1 and tier 2 cities to Zhongnan's land bank, we expect the segment gross margin to improve to 20-22% in 2021-2023. We expect the gross margin of construction segment to maintain at the current level of 8-10%. Overall, we forecast Zhongnan's gross margin to be in the range of 18-20% in 2021-2023.

Zhongnan's business strategy has shifted from scale expansion to control in financial leverage. As the company targets to maintain the land bank GFA / contracted sales GFA ratio at 2.5x in the next 12-18 months, the demand for land replenishment is still high. Nevertheless, the high cash collection rate of over 80% from contracted sale proceed is moderately sufficient to cover the operating cash outflow, and we expect Zhongnan's reported total debt growth to be at c. 5% per annum in the next two to three years. The improvement in financial leverage, measured by debt/capitalization and EBITDA interest coverage, is driven mainly by the higher revenue recognition from contracted sales and the controlled debt growth.

Key Assumptions

- Contracted sales growth: c. 8% growth for 2021-2023
- Contracted average selling price: c. 0% growth for 2021-2023
- Total land acquisition expenditures: RMB58-68 billion for 2021-2023

Key Financial Metrics

| 2019A-2023F | Debt/Land Bank | EBITDA/Interest | Debt/Capitalization | Quick Ratio |
|------------------|----------------|-----------------|---------------------|-------------|
| Weighted Average | 39.0% | 1.8x | 62.4% | 0.1x |

Source: Zhongnan's annual reports, Lianhe Global's adjustments and forecasts

Liquidity

Zhongnan held RMB32.9 billion of cash on hand (RMB24.4 billion unrestricted) at end-2020. The company also had c. RMB131 billion undrawn bank loan facilities at end-2020. Zhongnan's liquidity is moderate as it had c. RMB23.4 billion of debt due within one year at end-2020. The company has access to various financing channels onshore. The company is also planning to seek other financing channels such as ABN and ABS to diversify its funding sources.

Appendix I: Zhongnan's Rating Factors

| Rating Factors | Weight | Initial Rating |
|--|---------------|------------------|
| I. Market Demand Analysis | 15.0% | bbb+ |
| II. Business Analysis¹ | 45.0% | bb+ |
| III. Financial Analysis² | 40.0% | b |
| IV. Base Score | 100.0% | bb |
| V. Industry Risk | | bbb |
| Base Rating | | bb |
| VI. Qualifiers | | |
| Liquidity | | Neutral |
| Corporate Governance | | Neutral |
| Debt Structure and Financial Policy | | Neutral |
| Idiosyncratic Analysis | | Neutral |
| Stand-Alone Creditworthiness (SAC) | | BB |
| VII. External Support | | |
| Corporate Entity Support | | Not Applicable |
| Issuer Credit Rating | | BB/Stable |

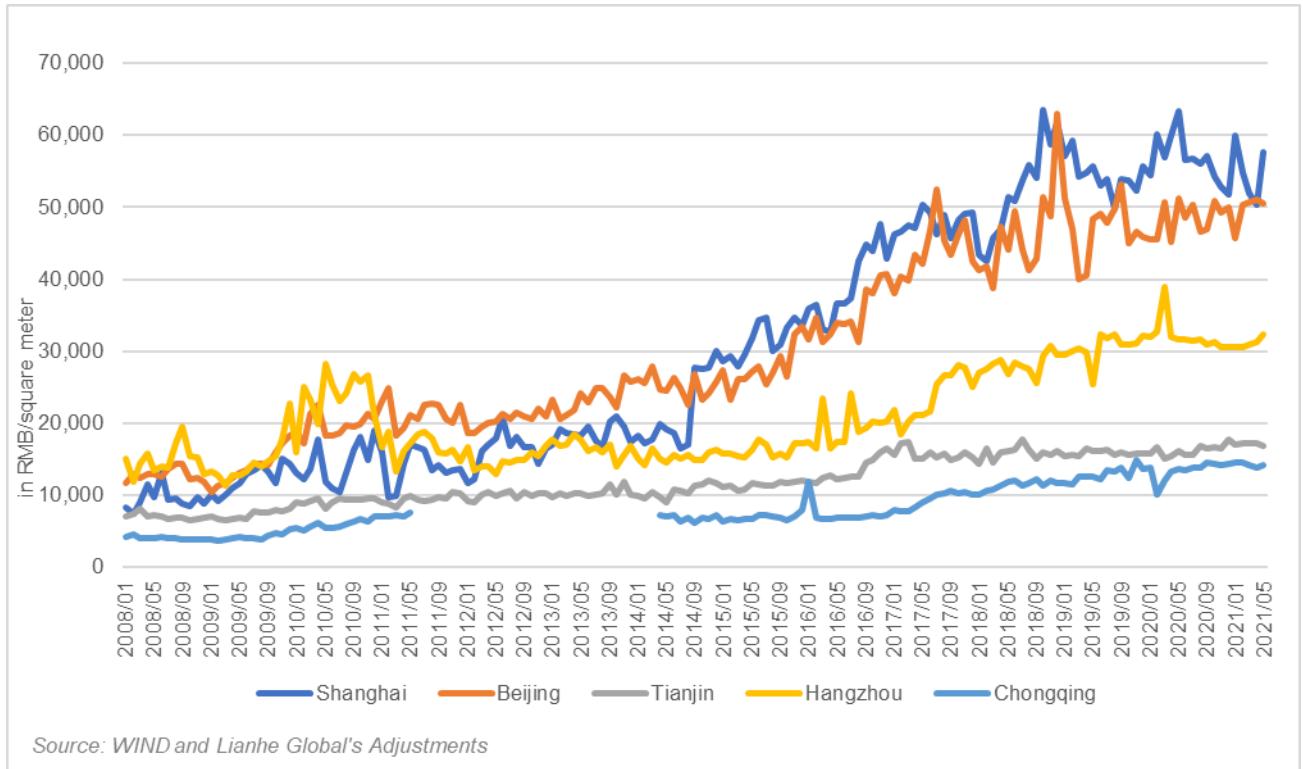
Source: Lianhe Global

¹ Business Analysis contains sub-factors of market position, diversification, competitive position, operating efficiency and profitability.

² Financial Analysis contains sub-factors of debt/land bank, EBITDA interest coverage, debt/capitalization and quick ratio.



Appendix II: Major Chinese Cities' Monthly Contracted Sales Average Selling Price



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