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HONG KONG RESEARCH
21st September 2009

Analyst: Sabina Cheng

Main Board Listing – Research

華南城控股有限公司
China South City Holdings Limited [Stock Code: 01668]

Sole Global Coordinator	:	Merrill Lynch International
Sole Sponsor and Joint Lead Managers (for Hong Kong Public Offering)	:	Merrill Lynch Far East Limited
Joint Bookrunners	:	Merrill Lynch International and BOCI Asia Limited

Sector : Real Estate
Business : Developer and operator of large-scale, integrated logistics and trade centers in the PRC

Total share offer: *1,500,000,000* shares
(25.0% of the enlarged share capital)
Public Offer: *150,00,000* shares (10%)
Placing: *1,350,000,000* shares (90%)

Price: HK$1.40 – HK$2.10 per share

Market Cap: HK$8.4 billion – HK$12.6 billion

Pro forma fully diluted FY09 P/E: 11.1x – 16.7x

Adjusted NTA per share: HK$1.06–HK$1.23

Staffing: 858 (as of 31st March 2009)

HK Public Offer period:
17th Sep 2009 – 22nd Sep 2009 noon

Receiving bankers:

The Hongkong and Shanghai Banking Corporation Limited

Bank of China (Hong Kong) Limited

Bank of Communications Co., Limited Hong Kong Branch

Hong Kong Share registrar:

Computershare Hong Kong Investor Services

Listing date: 30th September 2009

Business of China South City ("The Group")

The Group is one of the leading developers and operators of large-scale, integrated logistics and trade centers in the PRC. Its development consist of: i) site selection; ii) land acquisition; iii) project design, and iv) construction of trade centres and facilities for logistics, warehousing, and supporting commercial and residential functions. Its operational activities consist of the operation of: i) trade centres; and ii) facilities for logistics, warehousing, and supporting commercial and residential functions.

The Group has one integrated logistics and trade centre, China South City Shenzhen (CSCSZ). Phase One of CSCSZ commenced operation in December 2004, which has a textile and clothing trade centre in operation, while the residential facilities and a portion of the warehouse facilities were completed at end FY09. The Phase Two leather and accessories trade centre is scheduled for completion in 2H09. The entire CSCSZ Phase Two is expected to be finished by end-2012 upon the completion of all supporting facilities.

In addition, the Group has identified two new sites in Nanchang, Jiangxi Province and Nanning, Guangxi Province, for the future development of integrated logistics and trade centres, to be named China South City Nanchang (CSCNC) and ASEAN Logistics City (ASEANLC), respectively. Both projects have commenced in 4Q09 and will be completed in phases with full completion by 2014.

Shareholders after Listing (Assuming the over-allotment option is not exercised)

Accurate Gain Developments Limited – a private Hong Kong company, equally owned by one of the directors of the Group, Cheng Chung Hing, and his brother, Cheng Tai Po.	22.16%
Proficient Success Limited – a company owned by one of the directors of the Group, Cheng Chung Hing, and his brother, Cheng Tai Po, Yan Sau Man, Amy, a connected party of the Group as well as Michael Ho, an independent third party.	18.47%
Carrianna Development Limited – a company wholly owned by one of the founders of the Group, Ma Ka Cheung, through a company called Tak Sing Alliance Holdings Limited.	14.77%
Kings Faith International Limited – a company which is 80% owned by Leung Moon Lam, an executive director and co-founder of the Group and 20% owned by Wetter (China) Limited (Hong Kong). Wetter (China) Limited is owned as to 77% by Poly Faith Investment Limited, which is 50% held by Leung Moon Lam.	11.08%
Kinox Holdings Limited – a company wholly owned by Sun Kai Li, Cliff, one of the non-executive directors and co-founders of the Group.	3.69%
Luk Ka International Limited – a company equally owned by Ma Wai Mo, an non-executive director of the Group, and his brother, Ma Yu Hung.	3.69%
Medley Opportunity Fund, Limited – one of the noteholders of the Group	0.67%
Medley Opportunity Fund L.P. – one of the noteholders of the Group	0.08%
TRG Special Opportunity Master Fund Limited – one of the noteholders of the Group	0.39%
Public Shareholders	25%
	100.00%

Use of Proceeds

Net proceeds from the offer are estimated to be HK$2,419 million *(based on an offer price of HK$1.75, being the mid-point of the indicative price range and assuming the over-allotment option is not exercised)*

	HK$ million
For funding a portion of construction and development costs for its development projects in Phase Two of China South City Shenzhen	608
For funding a portion of development costs for Phase One of China South City Nanchang	1,210
For the development of potential new projects	143
For repaying the Notes in full	238
For repayment of bank borrowings and general working capital purposes	220

Financial Highlights

	Year ended 31st March		
	2007	**2008**	**2009**
	HK$ '000	**HK$ '000**	**HK$ '000**
Revenue	136,081	562,880	224,399
Gross profit	97,568	276,904	70,759
Operating profit	584,514	797,810	1,032,564
Change in fair value of investment properties	**601,071**	**670,871**	**1,153,903**
Profit attributable to shareholders	**174,375**	**556,075**	**754,048**
Gross profit margin	*71.7%*	*49.2%*	*31.5%*
Operating profit margin	*429.5%*	*141.7%*	*460.1%*
Net profit margin	*128.1%*	*98.8%*	*336.0%*
Net debt	505,211	739,373	2,276,464
Gearing ratio	20%	20%	51%

Revenues Breakdown

	Year ended 31st March					
	2007		2008		2009	
	HK$'000	%	HK$'000	%	HK$'000	%
Sale of properties	83,104	61.1%	46,759	8.3%	67,758	30.2%
Finance lease income	-	-	403,178	71.6%	9,913	4.4%
Rental income						
Lease of trade center units sold under cooperation and lease arrangements	17,463	12.8%	29,548	5.3%	33,709	15.0%
Lease of trade center units held as investment properties not for sale	15,313	11.2%	35,374	6.3%	37,142	16.5%
Other rental income	7,183	5.3%	12,529	2.2%	29,316	13.1%
Total rental income	**39,959**	**29.3%**	**77,451**	**13.8%**	**100,167**	**44.6%**
Hotel income	-	-	19,596	3.5%	25,505	11.4%
Property management service income	11,258	8.3%	14,267	2.5%	20,426	9.1%
Other fee income	1,760	1.3%	1,629	0.3%	630	0.3%
Total	**136,081**	**100.0%**	**562,880**	**100.0%**	**224,399**	**100.0%**

Strengths/Opportunities

- ✓ The Group plans to capitalise on the rising demand for large-scale, integrated trade centres in China using its competitive strengths of construction and operation of mega trade centres, replicating its successful business model in other regions out of Shenzhen. It has already signed master agreement for two projects in Nanchang and Nanning. Similar to the CSCSZ, the Group's new trade centres (CSCNC and ASEANLC) are located in key manufacturing and economic centres with easy access to different sorts of transportation like air, rails, waterways and sea, and roadways, aiming to support the China's economic development going forwards. Besides, the Group should have competitive advantages in established large trade centres in Nanchang and Nanning where trade centres there are rather fragmented without much supporting facilities.
- ✓ Continued increases in rental income is expected as the CSCSZ Phase Two will start to have income contribution in the coming two years, whilst that from the new centres, CSCNC and ASEANLC Phase One will be from FY2012 onwards.
- ✓ Shares of China South City are believed to be traded at around 40% discount to its NAV which should be fairly valued, given its closest peers with exposures in the PRC investment properties are trading with an average discount of 38.4% to NAV. Among the Group's peers, Soho China is trading at 41.8% discount to its NAV, GZI Real Estate Investment Trust is at 28.0% discount, Renhe Commercial is at 38.9% discount, Franshion Properties is at 52.7% discount, RREEF China Commercial Trust is at 43.1% discount and Kerry Properties is at 26.0% discount.

Weaknesses/Threats

- × After the Group paying down part of its outstanding debt using this IPO proceeds (HK$238 million for its Notes repayment in full and a portion of HK$220 million for its repayment of bank borrowings), gearing is still high. The Group still needs a total of RMB19.4 billion to complete the planned Nanchang project (about RMB9.3 billion) and Nanning project (about RMB 10.1 billion). Funding risk of the Group is remained if it is unable to obtain necessary external financing.
- × Operation results of the Group may also fluctuate due to the changes in the fair value of trade centre units and other facilities retained for rental income and capital appreciation. For FY2007, FY2008 and FY2009, fair value gains on investment properties accounted for 117.2%, 80.7% and 114.1% of net profit for the respective periods. Excluding the revaluation gains in fair value of investment properties, in fact, the Group incurred underlying losses over the same period.

Recommendation: Hit and Run

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