

Kerry Properties (683.HK)

Gradual Shift to Property Development in China

Hong Kong | Property | Company report

2 February 2017

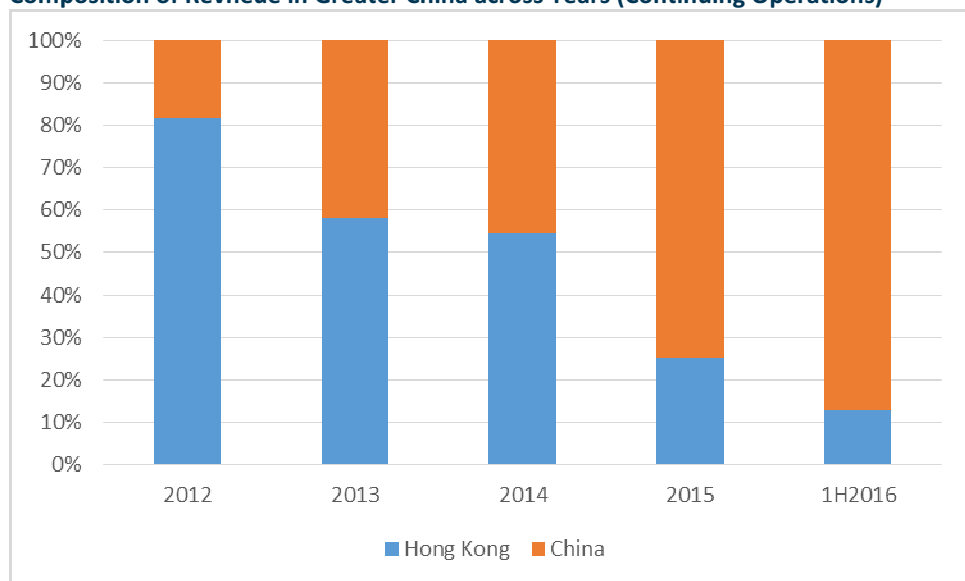
Investment Summary

- Several large projects in Hong Kong and China are expected to be completed in 2017, expecting to bring large revenue to the company
- Strong cooperation with Shangri-La in hotel business in its expansion in China
- Large and expanding property investment segment, which generates stable cash flow to the company

Company Overview

Kerry Properties is a property development and investment company and operates in both Hong Kong and China. Originally, Kerry Properties had a large logistics segment but ever since 2013 the segment has been spin-off and listed in Hong Kong Exchange as Kerry Logistics (636.HK). Therefore, Kerry Properties is now a company primarily concentrates on the property development and investment sector. Kerry Properties originally primarily operates in the property business in Hong Kong but since 2013, Kerry Properties has gradually shifted its main focus to property business in China, with its Chinese property business contributing 87% to the total revenue in 1H2016.

Composition of Revenue in Greater China across Years (Continuing Operations)



Source: Company Reports, Phillip Securities

China Segment: Kerry Properties has about 6,856,000 square foot of investment properties, including hotels, in China, and regularly achieves over 90% occupancy rate in major properties. Besides, the company also has property development in major cities such as Shenzhen, Shanghai and Hangzhou. In 1H2016, property development in China contributes HKD2.57Bn to the revenue, a YoY rise of 490%.

Hong Kong Segment: Kerry Properties has 2,785,000 square foot of investment properties and a majority of the GFA are for office and retail uses. Famous properties include Megabox. In terms of property development, the company targets at the high class residential property development in area such as Ho Man Tin and Kowloon Tong.

Buy

CMP: HKD 22.05
(Closing price as at 31 Jan 2017)
TARGET: HKD 26.40 (+19.73%)

COMPANY DATA

O/S SHARES (MN) :	1,443
MARKET CAP (HKDMN) :	31,821
52 - WK HI/LO (HKD):	26.00 / 16.66

SHARE HOLDING PATTERN , %

Kerry Group Limited	58.01
Schroders Plc	5.00

PRICE PERFORMANCE , %

	1M	3M	1Y
Kerry Properties	5.50	(11.09)	24.02
HSI	7.06	1.50	18.15

PRICE VS. HSI



Source: Phillip Securities (HK) Research

KEY FINANCIALS

HKD mn	FY14	FY15	FY16E	FY17E
Net Sales	14,664	10,393	9,977	12,478
Net Profit	7,836	6,070	5,118	5,840
EPS, HKD	4.6900	3.8300	3.5466	4.0459
PER, x	6.44	5.48	6.75	6.53
BVPS, HKD	55.4310	56.2666	58.9132	61.9590
P/BV, x	0.50	0.47	0.41	0.43
ROE, %	8.5	6.8	15.3	16.6

Source: Company reports, Phillip Securities Est.

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Increasing Exposure in China

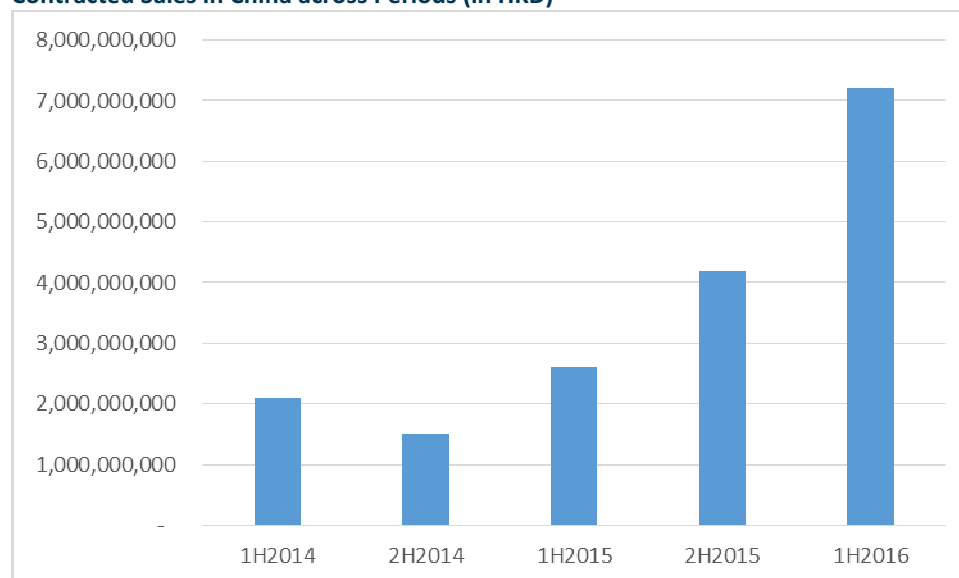
Kerry Properties has a rapid increase in exposure in China since 2015. Both property development and investment property achieved significant growth, in terms of revenue. Other than the ordinary property development and investment business, Kerry Properties has a hotel segment operation in China, which contributes to about 15% of the total revenue. The hotel segment also had sizable growth and achieved a 13% increase in revenue in 1H2016.

Property Development: The revenue from property development in China rose 490% in 1H2016 is due to the completion of several property construction projects, thereby allowing the recognition of revenue. In terms of property under development, the company has projects in many different cities in China, such as Shenzhen, Hangzhou and Nanjing, and has a large floor area being constructed. Selected properties under development include:

Property	GFA (Squared foot)	Completion Date
Castalia Court, Hangzhou	2,270,000	2017
Arcadia Court, Chengdu	2,150,000	2017
Arcadia Court, Nanjing	1,000,000	2017
Tianxin District, Changsha	3,200,000	2019
The Berylville II, Ningbo	629,000	In Progress

The above properties are primarily residential property development. At the same time, the company has many more integrated property complex, which consists of residential, commercial and retail components and they are in major cities such as Shenzhen and Hangzhou. Besides, the company's contracted sales has been on a steadily improving trend and the company has achieved the highest contracted sales in 1H2016 across recent years.

Contracted Sales in China across Periods (in HKD)



Source: Kerry Properties

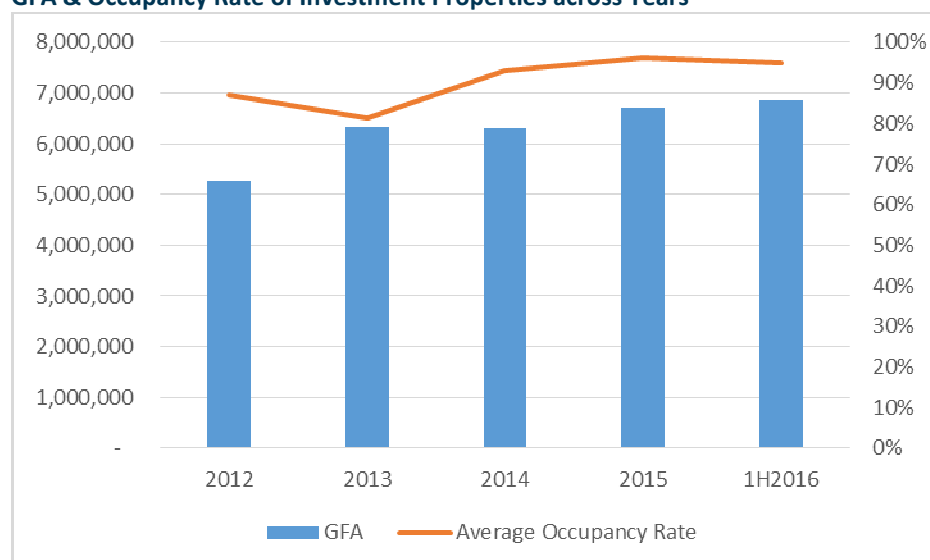
In 1H2016, the contracted sales in China was HKD7.2Bn, which is larger than the total recognised sales of HKD5.5Bn. Upon the completion of the property construction projects, we believe that the contracted sales will be gradually recognised and reflected in the income statement, assuring the stability of the company's operating results in the future.

Property Investment: The portfolio of investment property in China is large and expanding. In 1H2016, the revenue generated from property investment grew 10% while the total GFA only grew 1.8%, from 6,738,000 square feet to 6,856,000 square feet, signaling an increase in average rent especially occupancy rate has stayed roughly constant. Selected investment properties are as follow:

Property	GFA (Squared foot)	Occupancy Rate
Jing An Kerry Centre I & II	3,740,000	92%, 95%
Beijing Kerry Centre	2,500,000	97%
Shenzhen Kerry Plaza I & II	1,650,000	99%
Tianjin Kerry Centre	3,600,000	82%

The company has achieved, on average, over 90% occupancy in its major properties especially commercial and retail properties, which achieve over 95% occupancy rate in the last two years. Residential investment property relatively underperformed but still achieves on average 87% occupancy rate in both 2015 and 1H2016. With its investment properties being located in cities with high demand, such as Shanghai, Beijing and Shenzhen, we expect the high occupancy trend to continue and Kerry Properties can generate stable income from the existing properties.

GFA & Occupancy Rate of Investment Properties across Years



Source: Company Reports, Phillip Securities

Some of the investment properties under development are as follow:

Property	GFA (Squared foot)	Completion Date
Hangzhou Kerry Centre	2,200,000	2016
Qianhai, Shenzhen	2,200,000	2019
Shenyang Kerry Centre	13,000,000	In Progress

We expect the property projects under development, such as the Shenzhen, project, to bring sizable rental income to the company especially Qianhai in Shenzhen is one of the most focused business district by the Chinese government. Other integrated complex projects such as those in Hangzhou and Shenyang are also expected to bring stable cash flow to the company as well as diversify away the risk as they include retail, commercial and residential spaces for leasing.

Hotel: Kerry Properties has strong cooperation with Shangri-La, the well-known hotel resort operators in the world and many of the hotels developed by Kerry Properties are managed and operated by Shangri-La. Major hotel properties include:

Hotel	2013	Occupancy		
		2014	2015	1H2016
Kerry Hotel, Beijing	56%	74%	78%	81%
Shangri-La, Shanghai	37%	65%	74%	75%
Shangri-La, Shenyang	24%	44%	67%	64%
Kerry Hotel, Shanghai	58%	66%	71%	73%
Shangri-La, Tianjin	N/A	51%	56%	59%

The company has a few integrated complex, which consists of hotels not only named as Kerry Hotel, but also hotels jointly developed and managed by Shangri-La and named after Shangri-La. The following is the summary of hotels currently under development:

Hotel	Attributable Interest	Completion Date
Shangri-La, Hangzhou	75%	March 2016
Shangri-La, Jinan	55%	2017
Shangri-La, Kunming	55%	2019

Some of the hotels under development are managed by Shangri-La. We expect that Kerry Properties can leverage on the brand name of Shangri-La and generate stable cash flow from the current hotels and the future hotels.

High End Property Developer in Hong Kong

Kerry Properties primarily engages in the property development sector in Hong Kong and most of the properties developed by the company are located in the wealthy regions of Hong Kong. The property development segment however had an 85% drop in revenue because no construction projects were completed in 1H2016. Property investment achieved a 17% growth in revenue, which is mainly caused by the completion of renovation of a residential investment property in April 2015.

Property Investment: According to annual report 2015, Kerry Properties has 16 investment properties in Hong Kong, with the portfolio of properties spanning across residential, commercial and retail sectors. The total GFA of investment properties stay constant at around 2,785,000 square foot in 1H2016 but the revenue associated with the segment has increased, which is caused by an additional investment property put into use in April 2015. The following is the summary of large investment properties:

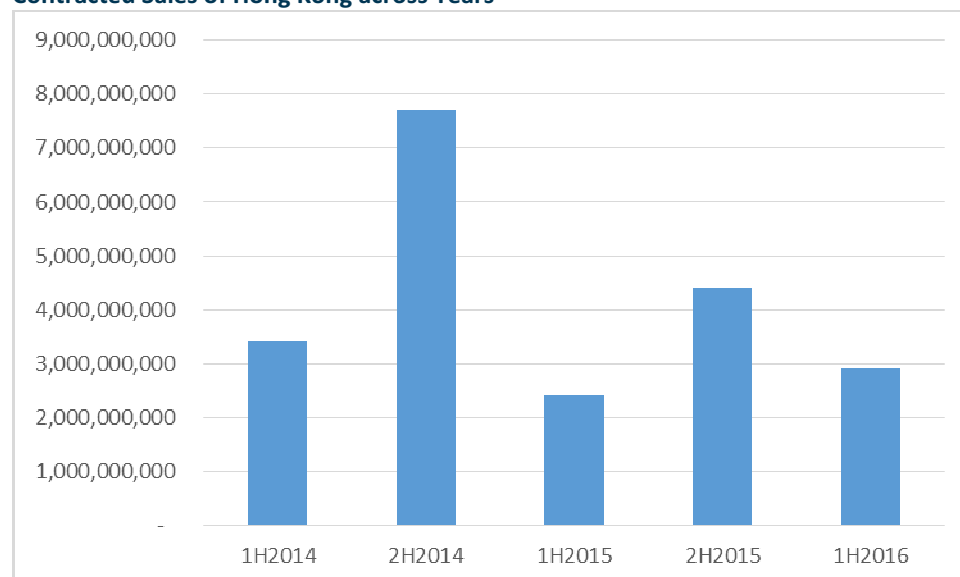
Property	GFA	Occupancy		
		2014	2015	1H2016
Megabox	1,100,000	99%	100%	100%
Enterprise Square Five	519,000	94%	98%	79%
Kerry Centre, Quarry Bay	511,000	99%	100%	100%
Branksome Grande	257,372	N/A	76%	100%

We expect property investment segment to generate stable cash flow and revenue to the company. However, we expect the room for growth is limited because of the constant GFA and the potential for growth is exhausted due to the high occupancy achieved in previous years.

Property Development: The property development in Hong Kong recorded significant drop in revenue. This is mainly caused by the fact that no properties were completed in 2016. The company currently has 7 property development projects under development, with GFA of about 2,769,697 square foot. Most of the properties, about 2,279,365 square foot or 82% of the GFA, are expected to be completed before 2018.

Property	GFA (Squared foot)	Completion Date
The Bloomsway	939,600	1Q2017
Mantin Heights	1,142,168	1Q2017
Shan Kwong Road Project	81,217	1Q2017
Beacon Hill Project	116,380	2Q2018
Hing Hon Road Project	47,962	1Q2019
LaSalle Road/Boundary Street	45,180	3Q2019
Nam Van Project, Macau	397,190	2Q2020

Contracted Sales of Hong Kong across Years



Source: Kerry Properties

With 3 properties scheduled to be completed in 2017, we expect the revenue from property development segment in Hong Kong to be large in 2017, especially the contracted sales of the large projects, The Bloomsway and Martin Heights, have already started its pre-sales as early as in 2H2015. Therefore, the revenue and cash flow in 2017 is expected to be sizable.

Future Outlook

China Market: The Chinese property market has been hot throughout 2016, leading to the Chinese government to adopt several cooling down policies and regulations to the property market.

- Policies include loan limitation, quantity limitation and increasing down payment ratio
- The policies have brought price adjustment and stabilisation in several large cities such as Shenzhen, Shanghai and Beijing
- According to statistics by Fang.com, the price for new apartment in Tier 1 cities has reduced its rate of growth
- In some Tier 2 cities, the rate of growth has started levelling off and stay stable at current level

We expect Kerry Properties to continue to perform well in the Chinese property market for the following reasons:

- The projects are geographically diversified across China and are usually integrated complex of hotels, offices, retail and residential properties
- Property investment represents a significant proportion of the company's revenue, reducing the company's exposure to the tightening regulation in the property development segment
- The company made large contracted sales, securing revenue ahead of the regulation tightening in October 2016.

With the large property development project reserve and investment properties in China, we expect China to continue to be the main driver of revenue growth and main source of income for the company. In fact, the investment properties in major cities especially the one in Qianhai, Shenzhen, which is currently under development, are full of potential and is the main focus of the Chinese government, allowing the company to generate sizable cash flow and revenue from these properties.

Hong Kong Market: The Hong Kong property market has been on a low transaction volume, in comparison with the high transaction volume achieved in the early years of the decade. The reasons for the low transaction volume could be summarized below:

- The adoption of the heavy stamp duties by the government, bringing down the transaction volume
- The expectation of a rate hike in Hong Kong in the foreseeable future, due to the relationship between HKD and USD

Property development segment is expected to be the main driver of revenue growth in Hong Kong because we believe growth of investment property segment is limited. Since high occupancy rate has been achieved but the GFA stays roughly stable, the growth potential is limited unless rent increases sharply. Comparing with China, the number of projects under development in Hong Kong is far fewer. Therefore, we expect Hong Kong segment to provide stable cash flow from its investment properties in the long term.

Financial Overview

In comparison with the property companies primarily engaging in the Chinese property sector, Kerry Properties has a relatively unlevered capital structure, with interest bearing debt contributing to only a small proportion in the capital structure. The summary of the gearing related ratio is as follow:

Ratio	2013	2014	2015	1H2016
LT Debt/Total Capital	25.44%	24.70%	18.79%	21.12%
EBITDA/Interest Expense	24.82x	15.22x	14.00x	13.96x

Source: Bloomberg

As shown from the above table, Kerry Properties's long term debt has been steadily decreasing and reach the recent ratio of about 20%. Interest coverage ratio has been deteriorating from 2013. However, the interest coverage ratio stays constant at about 14x after 2013, which is still considered to be healthy.

The profitability of Kerry Properties remain strong. In fact, the company operates in high demand cities such as Hangzhou and has a property investment business, which has high margin and provides stable source of income, hence a high overall profit margin.

Ratio	2013	2014	2015	1H2016
Overall Gross Margin	43.36%	42.34%	37.63%	47.18%
Operating Margin	85.19%	58.00%	53.04%	52.33%

Source: Bloomberg

Further breaking down the gross margin, we have the following:

Gross Margin	2013	2014	2015	1H2016
Property Development:				
China	40.46%	24.17%	17.93%	34.31%
Hong Kong	39.43%	40.66%	35.24%	33.76%
Property Investment				
China	69.43%	79.42%	78.43%	80.21%
Hong Kong	79.61%	75.75%	74.59%	78.89%

Source: Bloomberg

Property investment segment has a stable gross margin and the Hong Kong property investment yields a 79% gross margin in 1H2016. China segment performed well and rose from 69% in 2013 to 80% in 1H2016.

The gross margin of Hong Kong property development regularly stay above 30% and is due to the strategic positioning of the company in the high class residential property segment. China property development has quite a volatile gross margin and we believe it is due to the revenue arising from cities of different tiers, each having a vastly different gross margin, with Tier 1 cities having the greatest profit margin and Tier 3 cities having the lowest profit margin.

Valuation

The historical peer average P/E, P/B and P/S are 5.92x, 0.82x and 1.37x respectively. Kerry Properties's target price is therefore HKD26.40, with Buy rating assigned. (Closing price as at 31 Jan 2017)

Risk

Tightening policy in the property market
 Delay in construction

Financials

FYE	2013	2014	2015	2016F	2017F
Valuation Ratios					
Price Earnings (P/E)	7.00	6.44	5.48	6.75	6.53
Price to Book (P/B)	0.57	0.50	0.47	0.41	0.43
Per Share Data (HKD)					
EPS	9.1300	4.6900	3.8300	3.5466	4.0459
Book Value Per Share	52.4514	55.4310	56.2666	58.9132	61.9590
Dividend Per Share	0.9000	0.9000	0.9000	0.9000	1.0000
Growth & Margins (%)					
Growth					
Revenue	(8.2)	5.0	(29.1)	(4.0)	25.1
Operating Income	(10.3)	5.3	(42.9)	11.3	25.1
Net Profit	39.9	(17.1)	(22.5)	(15.7)	14.1
Margins					
Gross Profit Margin	43.4	42.3	37.6	41.1	41.1
Operating Profit Margin	33.8	33.9	27.3	31.7	31.7
Net Profit Margin	67.7	53.4	58.4	59.8	59.8
Key Ratios					
ROE (%)	17.4	8.5	6.8	15.3	16.6
ROA (%)	9.2	4.7	3.7	3.0	3.3
Income Statement (HKD Mn)					
Revenue	13,970	14,664	10,393	9,977	12,478
- Cost of Goods Sold	(7,912)	(8,456)	(6,482)	(5,875)	(7,348)
Gross Income	6,058	6,208	3,911	4,102	5,130
- Operating Expenses	(1,334)	(1,236)	(1,071)	(941)	(1,176)
Operating Income	4,724	4,972	2,840	3,161	3,954
- Net Non-Operating Gain	7,686	4,562	4,420	3,185	3,286
Pretax Income	12,410	9,534	7,260	6,346	7,240
- Income Tax Expenses	(2,957)	(1,698)	(1,190)	(1,228)	(1,400)
Net Profit	9,453	7,836	6,070	5,118	5,840

Source: Company, Phillip Securities (HK) Research Estimates
(Financial figures as at 31 Jan 2017)

PHILLIP RESEARCH STOCK SELECTION SYSTEMS

Total Return	Recommendation	Rating	Remarks
>+20%	Buy	1	>20% upside from the current price
+5% to +20%	Accumulate	2	+5% to +20% upside from the current price
-5% to +5%	Neutral	3	Trade within $\pm 5\%$ from the current price
-5% to -20%	Reduce	4	-5% to -20% downside from the current price
<-20%	Sell	5	>20% downside from the current price

We do not base our recommendations entirely on the above quantitative return bands. We consider qualitative factors like (but not limited to) a stock's risk reward profile, market sentiment, recent rate of share price appreciation, presence or absence of stock price catalysts, and speculative undertones surrounding the stock, before making our final recommendation

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