Asia Credit Research

OCBC Bank

Wharf Holdings Ltd: Credit Update

Monday, 28 August 2017

Changing tides

- In its 1H2017 results, Wharf Holdings Ltd ("Wharf") announced that it is in the process of demerging its wholly-owned subsidiary, Wharf Real Estate Investment Company Limited ("Wharf REIC"), and its 72%-owned Harbour Centre Development Limited ("HCDL") for a separate listing by way of introduction. Wharf will be divesting i-CABLE Communications Limited ("i-CABLE") by distribution in specie.
- The demerger of Wharf Real Estate Investment Company ("Wharf REIC") and Harbour Centre Development Limited ("HCDL") will significantly shrink Wharf's recurrent income stream and total assets. Moving forward, Wharf will be more reliant on its Chinese investment properties, hotels and logistics segments for recurring income.
- We think that the demerger may result in Wharf's net debt/ equity rising from 0.06x to 0.20-0.25x area. As such we are **downgrading Wharf's Issuer Profile to Neutral, and recommend holders of WHARF'21s to switch to WHEELK'21s.**

S&P: Not rated

Moody's: Not rated

Fitch: A-/Positive

Ticker: WHARF

Treasury Advisory

Corporate FX & Structured Products

Tel: 6349-1888 / 1881

Interest Rate Derivatives

Tel: 6349-1899

Investments & Structured Products

Tel: 6349-1886

GT Institutional Sales

Tel: 6349-1810

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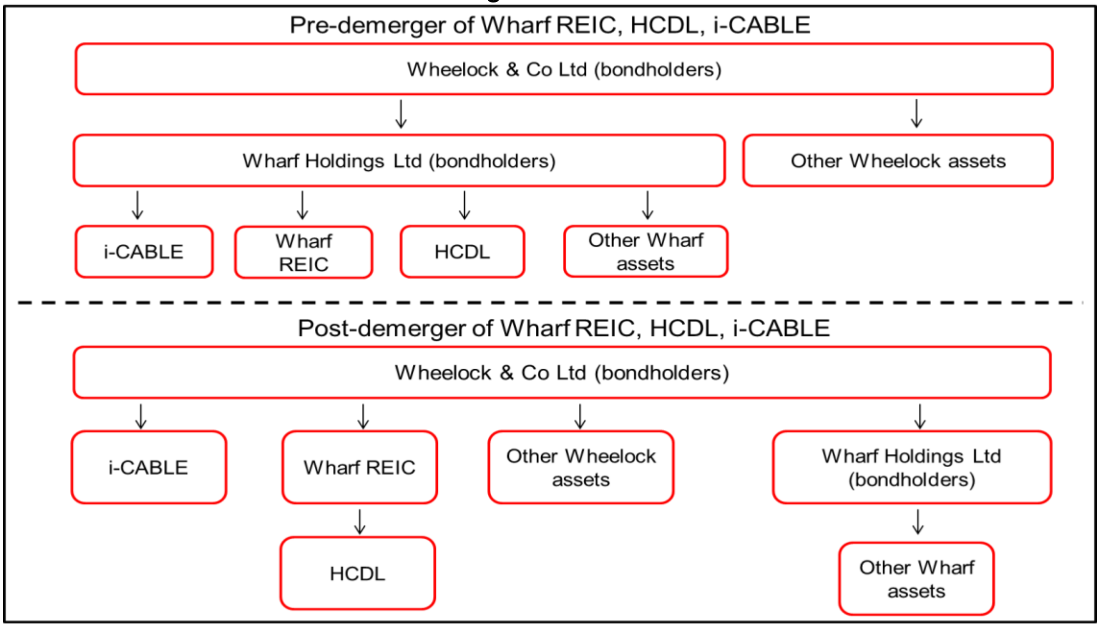
Background: Wharf is a HKSE-listed company that invests in retail, hotel and office property in China and Hong Kong. The company is also involved in communications, media & entertainment, and container terminals businesses. Wharf has strong experience and expertise in operating prime-location, high-quality commercial properties in Hong Kong. Wharf is 61.6% owned by its parent, Wheelock & Co Ltd ("WHEELK").

Following the strategic review post its 2016 results, Wharf has announced that it is in the process to demerge Wharf REIC, its wholly-owned subsidiary, and its 72%-owned subsidiary, HCDL through listing Wharf REIC separately by way of introduction. Wharf's management believes that the demerger will create a simple segregation between Wharf's assets, thereby providing investors with more and better choice. Shareholders of the company will receive distribution in specie of the new listed entity's shares. Wharf REIC will then hold HCDL and a portfolio of six investment properties in Hong Kong (Harbour City, Times Square, Plaza Hollywood, Crawford House, Wheelock House and The Murray). However, management did not elaborate on the potential impact that the demerger will have on Wharf's financials. In addition, Wharf will also be conducting a dividend in specie of its 74% stake in i-CABLE. This marks Wharf's exit from the Communications, Media & Entertainment industry completely. Wharf will convert HKD300mn of i-CABLE's debt into shares and distribute it along with the shares previously held by the group to Wharf's shareholders. Post demerger of Wharf REIC and i-CABLE, Wharf would no longer hold any shares in these two companies though the listed entities would have overlapping shareholders.

Structure for bondholders after demerger:



Source: Company, OCBC estimates

Demerger of Wharf Real Estate Investment Company and HCDL will significantly reduce recurring cash flows: The newly-listed entity will hold five of Wharf's current investment properties (Harbour City, Times Square, Plaza Hollywood, Crawford House, Wheelock House), Wharf's 72% owned stake in HCDL, and The Murray, (a hotel in Hong Kong held by HCDL that is currently under development, and due for completion in late 2017). Collectively, these six investment properties in Hong Kong have a value of HKD230bn and we estimate they contributed substantially all of Wharf's HK investment property segment's operating profits (1H2017: HKD6.2bn), which represents around 72% of Wharf's own operating profits. HCDL is a HKSE-listed entity that derives 85% of its operating profit from property development, with the remainder coming from investment and hotel properties. Management of HCDL has opined that its land bank is being depleted, and contribution from the property development sector will be substantially reduced beyond 2017. Post demerger, we estimate that the gross floor area ("GFA") of Wharf's investment properties in Hong Kong (as recorded on 31st Dec 2016) would decrease by 84% from 13.8mn sq ft to 2.2mn sq ft (of which 1.5 mn sq ft of GFA of the remaining properties are under development), and the remaining investment properties that Wharf retains would focus on the residential segment.

Wharf's net gearing will likely increase post demerger: Wharf did not elaborate on the impact of the demerger on its capital structure. As at 30 June 2017, HCDL is in a net cash position of HKD0.37mn, while i-CABLE is in a net debt position of HKD0.66mn. Comparatively, Wharf's is in a net debt position of HKD21.4mn. As such, the demerger of HCDL and i-CABLE will not have a significant impact on Wharf's net gearing. However, the demerger of the 6 investment properties, with combined valuation of over HKD230bn, would significantly shrink Wharf's balance sheet. Assuming that all cash and debt, with the exception of cash and debt held by HCDL and i-CABLE, stays on Wharf's balance sheet ("Assumed Scenario"), there will be a reduction in equity when assets are demerged. We estimate that gross debt/ equity would rise from 0.15x to 0.49~0.57x, while net debt/ equity would rise from 0.06x to 0.20~0.25x, based on 1H2017 financials. We note that certain borrowings are attached with financial covenants which require a minimum net tangible net worth, and we estimate that tangible net worth would decrease by 70~75% from HKD333bn to HKD85~102bn in our Assumed Scenario. However, we think that Wharf should not face any major financing issues after the demerger, given its good track record.

Post the demerger, Wharf's portfolio consists of investment properties in Mainland China, hotels, and logistics segments: For 1H2017, the investment properties in Mainland China, hotels, and logistics segments contributed an operating profit of HKD1.2bn, which represents 13.9% of the total operating profit for the group. Of this, investment properties in

China contributed HKD732mn, or 8.6% of total operating income. The largest contributor to this segment is Chengdu International Finance Square ("Chengdu IFS"), an investment property that contributed an operating profit of HKD259mn in 1H2017. Chengdu IFS has a GFA of 6.1mn sq ft, which represents 48.6% of completed investment properties in China. Other significant properties in China includes Wuxi International Finance Square (GFA: 2.0mn sq ft), Shanghai Wheelock Square (GFA: 1.2mn sq ft) and Shanghai Times Square (GFA: 0.97mn sq ft).

We believe that the operating income from this segment would increase steadily in the future as a large portion of investment properties in China, namely the 50%-owned Chongqing International Finance Square ("Chongqing IFS") and the fully-owned Changsha International Finance Square ("Changsha IFS") are currently under development, and are due for completion between 2017 and 2018. Upon completion, Chongqing IFS would have a GFA of 4.1mn sq ft (total property GFA excluding car park, net of sales of office towers), while Changsha IFS would have a GFA of 7.9mn sq ft. The retail and hotel segments of Chongqing IFS and Changsha IFS would be completed by 3Q2017 and 1Q2018 respectively. The retail segment represents 1.2mn sq ft of GFA in Chongqing IFS (of which Wharf owns a 50% equity stake), and 2.7mn sq ft of GFA in Changsha IFS. Management has announced that over 90% of retail floor areas for both Chongqing IFS and Changsha IFS have been leased or are under offer to retailers. The completion of these two properties would increase Wharf's attributable share of GFA of investment properties (including hotels) in China from 13.9mn sq ft to 24mn sq ft. As of 30 June 2017, 88% of offices in Tower Two, Three and Five of Chongqing IFS were sold. Additionally, Suzhou International Finance Square is due for completion in 2019, but may be demerged along with Wharf REIC as it is 80% held by HCDL. We do not rule out the possibility that Wharf might eventually subsume Suzhou IFS[1], given the strategic direction of Wharf and the rationale behind the demerger was to provide shareholders with a simple segregation.

Schedule of Wharf's investment properties in China:

			Approximate GFA ('000 sq ft)				
Property	Wharf's share of equity	Expected completion	Total	Office	Retail	Residential	Hotel
Completed properties	NA	NA	13,898	6,671	4,936	969	1,322
Suzhou IFS	57%	2018	3,222	1,667	23	1,276	256
Chongqing IFS*	50%	2017	2,234	1,424	612	0	198
Changsha IFS	100%	2018	7,864	4,200	2,739	0	925
Total			27,218	13,962	8,310	2,245	2,701

Completed properties include hotels | GFA for Changsha IFS shown on an attributable basis
Source: Company

Credit profile is expected to weaken post-demerger: After accounting for the demerger of the 6 investment properties, Wharf REIC and i-CABLE, coverage ratios would weaken. Under our Assumed Scenario, whereby substantially all debt stays on the balance sheet, using 1H2017's financials, EBITDA would decrease from HKD9.1bn to HKD2.4bn after the demerger, and EBITDA/ total interest ratio would decrease from 12.0x to 3.1x area. However, Wharf's credit profile may improve when its Mainland China investment properties are completed and leased out.

Operating margins from property development in China saw a huge improvement though this may be one-off: For 1H2017, revenue from property development in China decreased 29% y/y from HKD8.4bn to HKD6.0bn, mainly due to lower sales because of cooling measures imposed by the Chinese government. However, operating profit for the segment rose 31.9% y/y due to the recognition of profit from the completion of the later stages of Suzhou Times City, which yields higher margins. Profit before tax for the property development segment rose 108% y/y from HKD1.6bn to HKD3.4bn due to the higher operating margins (29.0% in 1H2017 vs 15.5% in 1H2016), an increase in contribution from joint ventures, and a write-back of impairment provisions on its development projects. Net order book increased from RMB27.4bn (HKD30.6bn) as at 31 Dec 2016 to RMB30.2bn (HKD34.8bn) as at 30 June 2017.

[1] In the event that Wharf subsumes Suzhou IFS, GFA will increase by another 3.2mn sq ft, of which 1.7mn sq ft is office spaces, and 1.3mn sq ft are residential spaces. Total GFA would increase to 27.2mn sq ft.

Despite the robust performance, operating margins may revert back to lower levels in the longer term. Management states that the phased completion of the later stages of Suzhou Times City yields higher margins, and that Suzhou Times City is due for completion in 2017.

Capital and development expenditure manageable, but depleting land bank remains a key concern: For 2H2017, projected capital and development expenditure is approximately HKD14.1bn, of which HKD7.7bn is for the development properties in China, and management believes that this could be self-financed by sales. We believe that this level is manageable, as the cash balance as of 30 June 2017 after accounting for the deconsolidation of HCDL and i-CABLE, and subtracting the remaining current borrowings, stands at HKD18.7bn.

However, Wharf faces a depleting land bank. Wharf is selling properties faster than it replenishes its land bank. This trend continued in 1H2017, as its land bank decreased further from 4.2mn sqm (~45mn sq ft) on 31 Dec 2016 to 3.4mn sqm (~37mn sq ft) on 30 Jun 2017. Replenishment of the land bank may be costly given the increase in land prices across China, especially in tier 1 cities. By 2019, most of Wharf's development properties (87% by GFA) would have completed. Post-2019, earnings visibility from property development may decrease.

Divestment of i-CABLE to have a marginally positive effect on financials: Wharf has also chosen to distribute its stake in i-CABLE via a distribution in specie to Wharf's shareholders. The transaction is scheduled for completion by Oct 2017, and we think this will not have a significant impact on Wharf's balance sheet. The divestment of i-CABLE would marginally improve Wharf's earnings, as i-CABLE's operating loss represents 2.6% of Wharf's operating profit for 1H2017.

Dividend neutral demerger would provide some level of comfort to bondholders: For 1H2017, Wharf paid out HKD4.8bn of dividends, which represents the second interim dividend of HKD1.57 per share for 2016. Wharf has also declared dividends of HKD0.64 per share for 1H2017, which amounts to HKD1.94bn. In the preceding financial years, operating income from investment properties alone has covered dividend payments by over 1.7x. Wharf has no specific dividend policy, but has been paying out 45~52% of core profit (profit excluding investment property revaluation surplus, mark to market changes on financial instruments and non-recurring items) for the preceding 5 financial years. Although core profit would decrease with the demerger of the investment properties (contributes HKD4.8bn, or 66% of 1H2017 core profit), we think that post-demerger shareholders would be receiving a larger portion of dividends from Wharf REIC instead, as management has stated that the demerger would be dividend neutral. This could help shift the dividend burden to Wharf REIC, which provides bondholders with some level of comfort.

Recommendation: In light of the plans for demerger, Wharf's once stable source of recurrent income may be divested. We note that WHARF'18s and '21s do not have a disposal clause. On the other hand, Wheelock & Co Ltd ("WHEELK") would be a beneficiary as it currently holds 60.94% of Wharf's outstanding shares and would receive Wharf REIC's shares. Cashflows (via dividends) from Wharf REIC's investment properties would hence flow directly to WHEELK (instead of being passed through Wharf). Therefore, we are downgrading Wharf's issuer profile to **<u>Neutral</u>**, and prefer WHARF '21s over WHEELK '21s for nearly equal yield in view of the potential demerger.

Outstanding SGD Bonds for Wharf and WHEELK:

Issue	Maturity / First Call Date	Outstanding Amount (SGDmn)	Ask Price	Ask YTW (%)	I-Spread	Bond Rating / Guarantor Rating
WHARF 4.3%'18s	28-Oct-18	250	103.45	1.30	10.6	Not Rated
WHARF 4.5%'21s	20-Jul-21	260	108.50	2.21	56.8	Not Rated
WHEELK 4.5%'21s	02-Feb-21	350	108.55	2.25	60.2	Not Rated

Indicative prices as at 28 August 2017
Source: Bloomberg

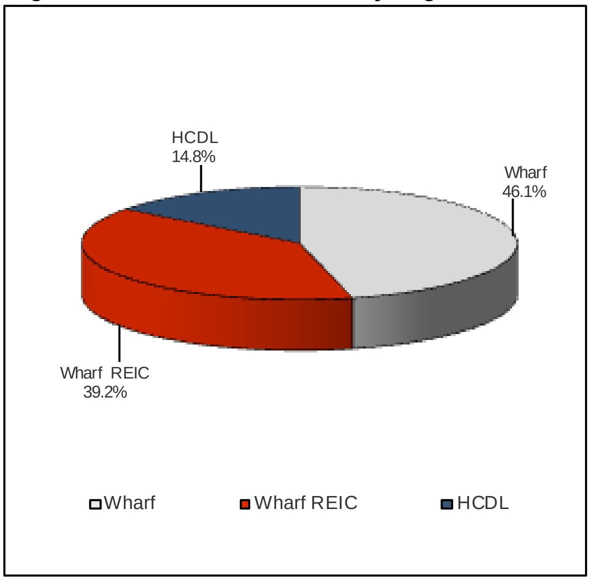
Wharf Holdings Ltd

Table 1: Summary Financials

Year Ended 31st Dec	FY2015	FY2016	1H2017
Income Statement (HKD'mn)			
Revenue	40,875	46,627	17,063
EBITDA	16,401	18,471	9,074
EBIT	14,853	17,065	8,553
Gross interest expense	2,557	2,039	758
Profit Before Tax	20,635	25,772	11,199
Net profit	16,024	21,440	8,441
Balance Sheet (HKD'mn)			
Cash and bank deposits	23,510	36,957	29,781
Total assets	443,916	443,827	438,484
Gross debt	70,707	60,794	51,207
Net debt	47,197	23,837	21,426
Shareholders' equity	317,180	325,406	333,127
Total capitalization	387,887	386,200	384,334
Net capitalization	364,377	349,243	354,553
Cash Flow (HKD'mn)			
Funds from operations (FFO)	17,572	22,846	8,962
* CFO	24,053	29,084	5,700
Capex	6,849	14,077	NA
Acquisitions	1,340	-4,230	NA
Disposals	6,727	12,066	NA
Dividends	5,851	6,440	4,762
Free Cash Flow (FCF)	17,204	15,007	NA
* FCF Adjusted	16,740	24,863	NA
Key Ratios			
EBITDA margin (%)	40.1	39.6	53.2
Net margin (%)	39.2	46.0	49.5
Gross debt to EBITDA (x)	4.3	3.3	2.8
Net debt to EBITDA (x)	2.9	1.3	1.2
Gross Debt to Equity (x)	0.22	0.19	0.15
Net Debt to Equity (x)	0.15	0.07	0.06
Gross debt/total capitalisation (%)	18.2	15.7	13.3
Net debt/net capitalisation (%)	13.0	6.8	6.0
Cash/current borrowings (x)	2.8	2.4	3.0
EBITDA/Total Interest (x)	6.4	9.1	12.0

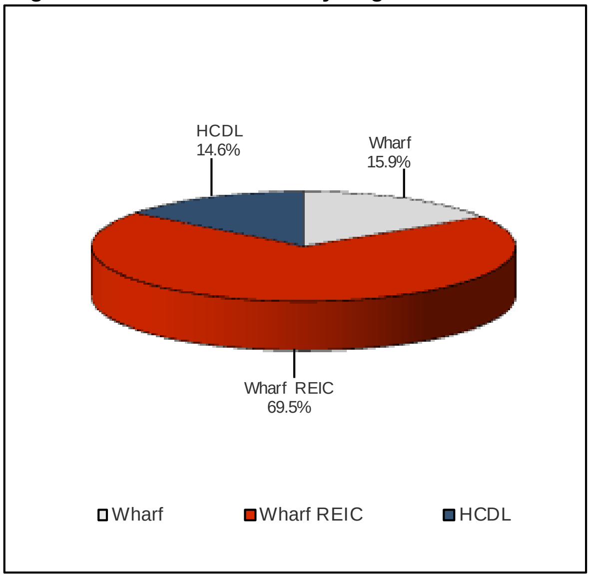
Source: Company, OCBC estimates
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: Revenue breakdown by Segment - 1H2017



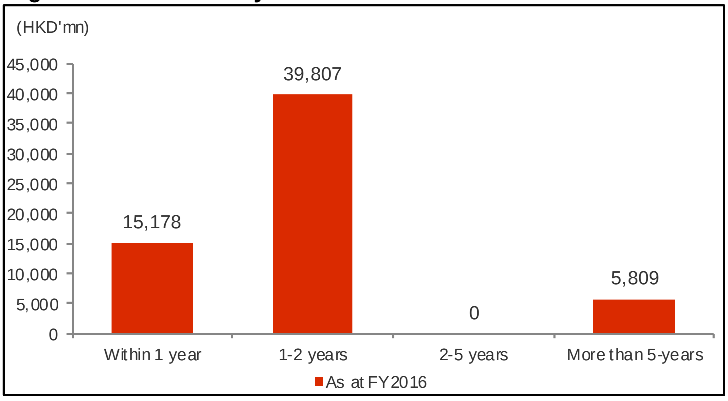
Source: Company, OCBC estimates

Figure 2: EBIT breakdown by Segment - 1H2017



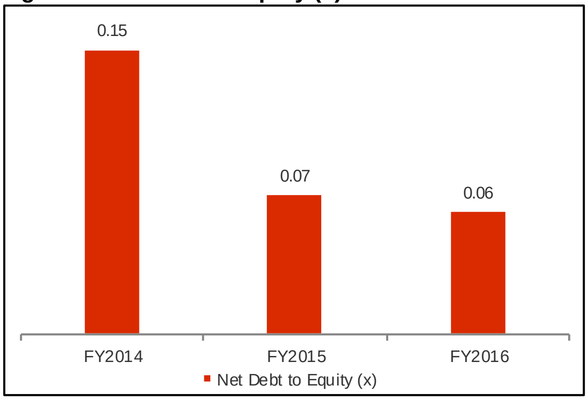
Source: Company, OCBC estimates

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

The credit research team would like to acknowledge and give due credit to the contributions of Andrew Chok Rong Yao.