**Credit Opinion** 21 June 2016

# SOHO China Limited

Hong Kong

| | |
|---|---|
| Category: | Corporate Rating |
| Rating Type: | Solicited Rating |
| Industry: | Commercial Property |
| Long-term Credit Rating: | AAg- |
| Rating Outlook: | Stable |


Analysts:

Elle Hu elle_hu@ccxap.com

David Zhu david_zhu@ccxap.com

Director of Credit Ratings:

Guo Zhang guo_zhang@ccxap.com

Tel.: +852-2860 7111


## Key Indicators

| SOHO China Limited [1] | 2015 | 2014 | 2013 |
|---|---|---|---|
| Total assets (RMB billion) | 71.8 | 76.8 | 77.8 |
| Total assets (USD billion) [2] | 11.1 | 12.6 | 12.8 |
| Total revenue (RMB billion) | 1.0 | 6.1 | 14.6 |
| Total revenue (USD billion) [2] | 0.2 | 1.0 | 2.4 |
| Gross Margin (%) | 73.7 | 50.5 | 55.5 |
| EBITDA Margin (%) | 201.9 | 104.0 | 80.8 |
| Total debt / Total capital (%) | 32.2 | 33.4 | 30.7 |
| Net debt / Total equity (%) | 23.5 | 19.2 | 16.7 |
| Total debt / EBITDA (x) | 8.9 | 3.2 | 1.4 |
| Net debt / EBITDA (x) | 4.4 | 1.2 | 0.5 |
| EBITDA / Interest (x) | 1.5 | 5.9 | 9.4 |

[1] Consolidated financial statements in accordance with Hong Kong Financial Reporting Standards audited by PwC

[2] Exchange rates for 2013 (1 USD = 6.0969 CNY), 2014 (1 USD = 6.1190 CNY), and 2015 (1 USD = 6.4936 CNY) announced by PBOC

Source: Company data, CCXAP research

## Rating Drivers

- Solid track record in leasing and managing commercial properties
- Sizable portfolio with high quality assets in Beijing and Shanghai
- Prudent financial management policy
- Deteriorating credit metrics
- Good liquidity profile and access to capital

## Rating Rationale

SOHO China Limited ("SOHO China" or "the Company") has implemented the transition of its business model from "build-to-sell" to "build-to-hold". The AAg- rating is supported by the Company's (1) important franchise value as a commercial property developer and operator in China; (2) sizable property portfolio of approximately 1.7 million sqm in gross floor area; (3) modern and high quality commercial buildings in the prime locations of Beijing and Shanghai; (4) prudent financial policy of relatively low leverage and well-managed debt structure; and (5) strong access to capital especially in the onshore bond market. However, the rating also takes into consideration of (1) a longer time to generate stable rental income; and (2) deteriorating credit metrics due to the decline in property sales.

## Rating Outlook

The stable outlook reflects that SOHO China will manage its investment property portfolio at a stable growth pace, focusing on the high quality of its products and services. Furthermore, we expect that the Company will continue to maintain its prudent financial policy.

**What could upgrade the rating?**

The rating could be upgraded if (1) the Company's stable rental income improves its credit metrics; (2) the Company's cash reserve increases and liquidity strengthens; and (3) disposal of non-core assets provides a positive impact on profitability.

**What could downgrade the rating?**

The rating could be downgraded if (1) the operating environment in China deteriorates significantly; (2) the Company's credit metrics become worse than anticipated; and (3) lack of liquidity which hinders ongoing operations.

## Corporate Profile

In March 2002, SOHO China was incorporated in the Cayman Islands with limited liability. In October 2007, SOHO China was listed on the Hong Kong Stock Exchange (Stock Code: 0410.HK). Mr. Pan Shiyi and Mrs. Pan Zhang Xin Marita are the Company's co-founders. Capevale Limited (Cayman) is the Company's controlling shareholder, which is beneficially owned by Mrs. Pan Zhang Xin Marita through a trust arrangement. As of 31 December 2015, Capevale Limited (Cayman) held 63.9309% of the Company's shares.

SOHO China focuses on developing, leasing, and managing commercial office buildings in Beijing and Shanghai. As announced in August 2012, SOHO China has shifted its business model from "build-to-sell" to "build-to-hold" by increasing the proportion of investment properties.

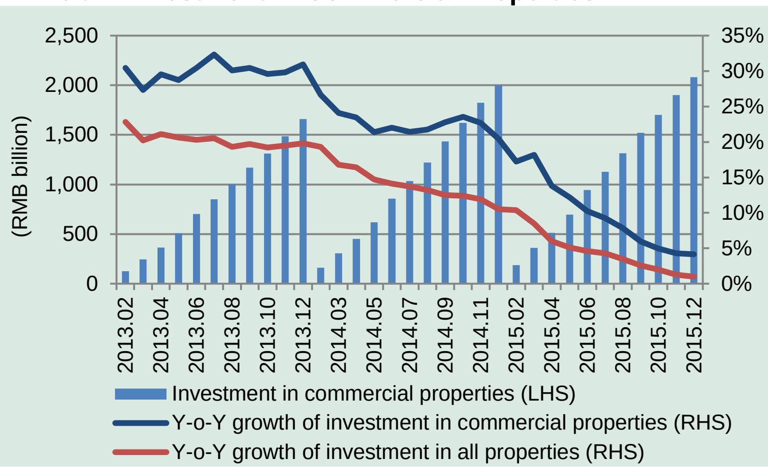
As of 31 December 2015, SOHO China reported consolidated total assets of RMB 71.8 billion, with investment properties valued at RMB 55.0 billion. In 2015, SOHO China generated total revenue and net income of RMB 995 million and RMB 563 million, respectively.

## Detailed Rating Considerations

### 1. Strong office-leasing market in the first-tier cities

China has experienced gradual development of the commercial real estate market along with its economic growth. In view of China's faltering economy, the growth rate of investment in commercial properties has slowed down, yet outperformed that of other property types. In 2015, with more liquidity in the market, real estate prices resumed strength, especially in first-tier cities. The constrained supply in core business areas and the sustained demand for high quality office space resulted in low vacancy rates and high rental growth in first-tier cities.

**Exhibit 1. Investment in Commercial Properties**




Source: National Bureau of Statistics of China, CCXAP research

Beijing has the most expensive Grade A office space in China. Demand from domestic IT firms escalated in the areas of Wangjing and Zhongguancun, while domestic finance companies dominated the leasing market in Financial Street. With the strong demand from domestic IT and financial sectors, net take-up achieved a three-year high of 420,000 sqm in 2015, and vacancy rates dropped by 0.1 of a percentage point to 3.6% during the period. Average rents stabilized at RMB 320 per sqm per month at the end of 2015.

The Shanghai Grade A office market has balanced supply-and-demand dynamics. Driven by strong demand in the projects handed over during the year, overall net take-up in 2015 has hit a record high since 2011. Net take-up of office space in core areas was approximately 740,000 sqm, and vacancy rates fell by 2.0 percentage points to 6.1%. Average rents in core areas increased by 1.4% YoY to RMB 265 per sqm per month at the end of 2015. Rents in Pudong outperformed those in Puxi.

Despite the slowdown in the Chinese economy and high volatility in stock market, financial services companies remain the main demand driver for prime office space. Co-working space in office buildings will also become popular among tenants such as internet companies. Although the influx of supply in 2016 will put pressure on both rental and occupancy rates, we expect the office market in Beijing and Shanghai will gain strong leasing momentum to drive steady performance.

**Exhibit 2. Beijing Grand A Office Market**

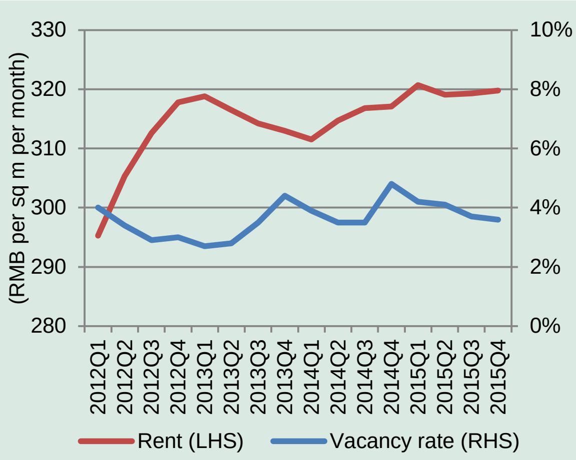
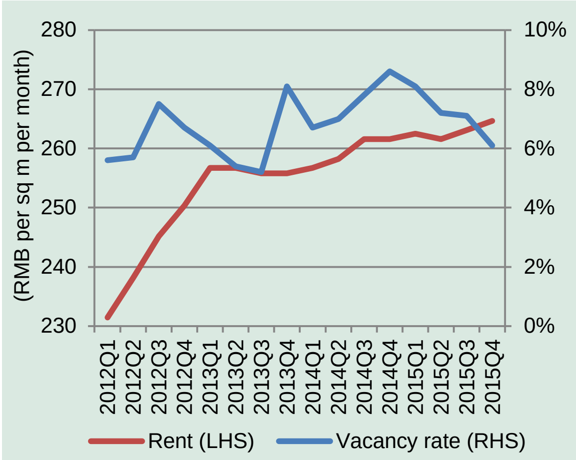



**Exhibit 3. Shanghai Grand A Office Market**




Note: Shanghai core market consists of Pudong and Puxi, excluding the decentralized areas.

Source: Savills, CCXAP research

## 2. Good asset quality of investment property portfolio

SOHO China's rating is underpinned by the size and quality of its investment property portfolio, which includes 11 commercial properties of modern features and quality management. SOHO China has kept its leading position in terms of size of prime office buildings in Beijing and Shanghai, which supports the future development of its leasing business.

As of 31 December 2015, SOHO China held investment properties with total gross floor area ("GFA") of 1.7 million sqm, of which the leasable area is 1.2 million sqm. The projects are mainly located in the prime locations of Beijing and Shanghai. The portfolio is split by floor area into 70% of office space and 30% of retail space, given the Company's focus on the operations of commercial office properties. Except for Qianmen Avenue, the retail space focuses on providing functional retail services to the office tenants.

SOHO China has three projects under development, which will be completed by end of 2018. The land acquisition cost of these projects is RMB 7.1 billion, and the development cost is estimated at RMB 4.7 billion. The future capital expenditure is manageable given the Company's strong track record of commercial property development. At the end of 2015, the percentage of development projects relative to total assets reduced to 13% from 24%, following the completion of two projects in Shanghai (Hongkou SOHO and Bund SOHO) in 2015. We expect the development pipelines will decrease over the next three years and the completed properties will begin to generate rental income.

As of 31 December 2015, SOHO China's investment properties were valued at RMB 55.0 billion, a 4.0% YoY growth from 2014. The valuation is conducted by independent valuers and reviewed by the Company's internal team on an annual basis. The fair value of the completed investment properties is determined primarily by the market comparison method with reference to the sales prices of comparable properties, whereas the fair value of the properties under development is generally appraised by the residual method.

**Exhibit 4. Investment Property Portfolio as of 31 December 2015**

| Project | Location | Completion Date | Effective Interest | Total GFA (sq.m.) | Leasable GFA (sq.m.) | Office (sq.m.) | Retail (sq.m.) |
|---|---|---|---|---|---|---|---|
| **Completed Projects** | | | | | | | |
| Qianmen Avenue | Beijing | 2010/2012 | 100% | 54,691 | 54,691 | – | 54,691 |
| Wangjing SOHO Tower 3 | Beijing | Sep 2014 | 100% | 134,063 | 133,766 | 123,568 | 10,198 |
| Guanghualu SOHO II | Beijing | Nov 2014 | 100% | 165,201 | 94,279 | 63,308 | 30,971 |
| SOHO Century Plaza | Shanghai | 2012 | 100% | 60,501 | 42,741 | 42,522 | 219 |
| SOHO Fuxing Plaza | Shanghai | Sep 2014 | 100% | 135,052 | 88,234 | 50,057 | 38,177 |
| Sky SOHO | Shanghai | Nov 2014 | 100% | 235,488 | 128,129 | 102,968 | 25,161 |
| Hongkou SOHO | Shanghai | Jul 2015 | 100% | 93,757 | 69,892 | 65,315 | 4,577 |
| Bund SOHO | Shanghai | Aug 2015 | 61.5% | 141,043 | 73,781 | 50,439 | 23,342 |
| Others [1] | Beijing / Shanghai | | 100% | 162,079 | 115,044 | 60,902 | 54,142 |
| **Projects Under Development** | | | | | | | |
| SOHO Tianshan Plaza | Shanghai | Nov 2016 | 100% | 170,238 | 115,619 | 73,673 | 41,947 |
| SOHO Leeza | Beijing | Nov 2018 | 100% | 172,800 | 133,780 | 123,780 | 10,000 |
| Gubei Project | Shanghai | Dec 2018 | 100% | 158,648 | 113,416 | 52,738 | 60,678 |
| | | | | **1,683,562** | **1,163,372** | **809,270** | **354,103** |

[1] Others represent unsold units of projects previously developed by the Company.

Sources: Company data, CCXAP research

SOHO China launched its SOHO 3Q platform in February 2015, a shared office space product provided to tenants on flexible terms. As of 31 December 2015, SOHO China had built 11 SOHO 3Q centers in Beijing and Shanghai with more than 10,000 seats, creating a business community of more than 30,000 members. The Company also plans to extend its business into third-party office buildings outside of Beijing and Shanghai in the next few years. We believe that SOHO 3Q will become a new growth driver for the Company.

## 3. Growing rental income in line with strategic transition

SOHO China established its online leasing platform where all the leasing related information is available. Lease contracts have standardized terms, and rental payments (monthly or quarterly) are settled through automatic bank transfer. The open and transparent leasing platform helps to enlarge the potential tenant base and improve the efficiency of leasing activities.

New office properties usually require one year upon completion to achieve good occupancy and generate stable rental income. As of 31 December 2015, Wangjing SOHO Tower 3 in Beijing and SOHO Century Plaza in Shanghai were almost fully leased. Guanghualu SOHO II and SOHO Fuxing Plaza also achieved satisfactory leasing results. There was growing demand from domestic financial institutions and IT related companies but shrinking demand from retail, consumer goods, and manufacturing companies. We believe that the Company has the capability to attract and retain high-quality tenants.

SOHO China's rental income is underpinned by medium to long-term leasing contracts. The majority of office leases are with terms of 3 to 5 years, while the leases of retail tenants are longer, from 5 years or more. The weighted average lease expiry (WALE) was about 3.5 years across the portfolio.

SOHO China enjoys premium rentals and rental increases, which reflect the supply-and-demand dynamics in core business areas. For the newly signed leases in 2015, Wangjing SOHO and SOHO Century Plaza achieved an increase in rental rate of 25.1% and 24.7%, respectively.

SOHO China reported a rental income of RMB 1,052 million in 2015, as compared to RMB 424 million in 2014 and RMB 279 million in 2013. The compound annual growth rate is calculated as 94.2%. The increase in rental income over the period was driven by (1) strong demand for office space in Beijing and Shanghai, and (2) expansion of SOHO China's investment property portfolio. We expect that the Company's rental income will continue to grow due to larger leasable area and higher occupancy rates.

**Exhibit 5. Rental Income and Occupancy Rates in 2013-2015**

| Project | Leasable GFA [1] (sq.m.) | Rental Income (RMB Million) | | | Occupancy Rate [2] (%) | | |
|---|---|---|---|---|---|---|---|
| | | 2015 | 2014 | 2013 | 2015 | 2014 | 2013 |
| Qianmen Avenue | 35,317 | 121 | 108 | 82 | 81.4 | 76.2 | 65.4 |
| Wangjing SOHO Tower 3 | 133,766 | 289 | 48 | – | 100.0 | 68.9 | – |
| Guanghualu SOHO II | 94,279 | 90 | – | – | 84.7 | 6.0 | – |
| SOHO Century Plaza | 42,741 | 110 | 108 | 87 | 100.0 | 94.5 | 99.0 |
| SOHO Fuxing Plaza | 88,234 | 179 | 31 | – | 94.5 | 64.4 | – |
| Sky SOHO | 128,129 | 70 | 2 | – | 72.9 | 7.3 | – |
| Hongkou SOHO | 69,892 | 5 | – | – | 33.9 | – | – |
| Bund SOHO | 73,781 | 20 | – | – | 60.5 | – | – |
| Others | 115,044 | 169 | 127 | 110 | – | – | – |
| | **800,557** | **1,052** | **424** | **279** | | | |

[1] Attributable to the Group as of 31 December 2015

[2] Occupancy rate for office and retail, including SOHO 3Q (if any)

Sources: Company data, CCXAP research

## 4. Declining property sales during transition

SOHO China has been a property developer, focusing on developing and selling iconic commercial properties in Beijing and Shanghai. Given the strategic transition from a property developer to a property operator, SOHO China reported a decline in property sales over the last three years.

The turnover of property development recorded RMB 5.7 billion in 2014 and RMB 14.3 billion in 2013, which were generated mainly from Wangjing SOHO Towers 1&2, Galaxy SOHO and SOHO Zhongshan Plaza. SOHO China almost did not sell any property in 2015. In September 2015, SOHO China disposed of its entire equity interest in Zenda Bund, an indirectly-owned joint venture, at a consideration of RMB 8.493 billion. The Company recognized net gain on disposal of RMB 1.1 billion in its 2015 financial accounts. The asset disposal serves as an additional support to the Company's bottom-line results.

## 5. Key credit metrics deteriorate due to weaker revenue generation

SOHO China commenced the transition of its business model in 2012 with the aim of generating more stable and recurring earnings from rental income. However, due to the decrease in overall revenue, its major credit metrics deteriorated over the last three years.

Despite the increase in rental income, SOHO China's total revenue declined due to the decrease in development income. The Company achieved total revenue of RMB 1.0 billion in 2015, as compared to RMB 6.1 billion in 2014 and RMB 14.6 billion in 2013. On the other hand, SOHO China attained a higher margin from property leasing. The gross profit margin for 2015, 2014 and 2013 was 73.8%, 50.5%, and 55.5%, respectively.

As the property sales shrank, selling expenses declined over the last three years. Given the expansion of its investment property portfolio, other operating expenses continued to rise. Financial expenses increased to RMB 0.9 billion in 2015 from RMB 0.3 billion in 2014. This is mainly driven by the decrease in capitalized interest as the number of properties under development decreased during the year.

SOHO China's credit metrics became weak for its rating. The total debt-to-EBITDA ratio climbed to 8.9x in 2015 from 3.2x in 2014 and 1.4x in 2013, while the net debt-to-EBITDA ratio surged to 4.4x in 2015 from 1.2x in 2014 and 0.5x in 2013. The EBITDA interest coverage ratio, as measured by EBITDA / (interest expense + capitalized interest), dropped to 1.5x in 2015 from 5.9x in 2014 and 9.4x in 2013. The interest included the fees related to the consent solicitation and tender offer of senior notes during 2015.

## 6. Strong balance sheet reflects prudent financial management

SOHO China has demonstrated prudence in its financial management, with adequate cash balance and low debt leverage. The Company's financial policy is to maintain its total debt amount below RMB 20 billion and net gearing ratio below 50%.

As of 31 December 2015, SOHO China's cash on hand (cash and cash equivalents and bank deposits) declined by RMB 3.5 billion YoY to RMB 9.0 billion. This was mainly due to the decrease in its operating profits and the repurchase of its senior notes during 2015. The encumbered assets, including pledged investment properties and restricted bank deposits, amounted to 32% relative to total assets. The Company has the financial flexibility to monetize its unencumbered assets for future funding needs.

As of 31 December 2015, SOHO China reported total debt amount (bank loans and senior notes) of RMB 17.9 billion, reduced by RMB 2.4 billion YoY. The bank loans were either collateralized by land use rights, properties, and shares of certain subsidiaries or guaranteed by certain subsidiaries. The capitalization ratio, as measured by total debt to total capital, was 32.2% at 2015 year-end. The net gearing ratio, as measured by net debt to total equity, was 23.5% at 2015 year-end. We note that debt repayments of RMB 1.9 billion and RMB 3.5 billion will expire in 2016 and 2017, equivalent to 11% and 20% of total debt, which are considered manageable.

SOHO China has reduced its HKD/USD exposure to contain exchange rate risk and entered into interest rate swap for its USD loans to hedge interest rate risk. As of 31 December 2015, the debt portfolio consisted of 56% of offshore debt and 44% of onshore debt, versus 73% offshore and 27% onshore in 2014. In early June 2016, SOHO China redeemed all of its outstanding senior unsecured notes due 2022. The Company will continue to refinance offshore borrowings by onshore borrowings at lower funding costs.

## 7. Good liquidity profile and low refinancing risk

SOHO China has an adequate liquidity profile. The net cash flow from operating activities was negative during 2014 and 2015 due to the decrease in property sales. Although operating cash flow is weakening, SOHO China’s cash reserve and committed bank facilities will be sufficient for its existing project development.

In January 2016, SOHO China’s mainland subsidiary issued domestic corporate bonds on the Shanghai Stock Exchange, with an issue amount of RMB 3 billion at a coupon rate of 3.45% for a term of 3 years. The expansion of the onshore bond market has strengthened the refinancing capability of Chinese real estate companies.

## Appendix. CCXAP's Credit Rating Symbols and their Meaning

China Chengxin (Asia Pacific) Credit Ratings Company Limited uses simple, consistent, and comparable rating symbols expressed in letters to represent the credit worthiness of rated entities and rated debt issues.

### A. Long-Term Credit Ratings

A long-term credit rating refers to a rating for a period of more than 12 months.

| Rating Symbol | Definition |
|---|---|
| **AAAg** | Capacity to meet commitments on short-term and long-term debts is extremely strong. Business is operated in a virtuous circle. The foreseeable uncertainty on business operations is minimal. |
| **AAg+**<br>**AAg**<br>**AAg-** | Capacity to meet short-term and long-term financial commitments is very strong. Business is operated in a virtuous circle. Foreseeable uncertainty in business operations is relatively low. |
| **Ag+**<br>**Ag**<br>**Ag-** | Capacity to meet short-term and long-term commitments is strong. Business is operated in a virtuous circle. Business operation and development may be affected by internal uncertain factors, which may create fluctuations in profitability and solvency of the issuer. |
| **BBBg+**<br>**BBBg**<br>**BBBg-** | Capacity to meet financial commitment is considered adequate and capacity to meet short-term and long-term commitments is satisfactory. Business is operated in a virtuous circle. Business is affected by internal and external uncertainties. Profitability and solvency may experience significant fluctuation. Principal and interest may not be sufficiently protected by the terms of agreement. |
| **BBg+**<br>**BBg**<br>**BBg-** | Capacity to meet short-term and long-term financial commitment is relatively weak. Financial commitment towards short-term and long-term debts is below average. Status of business operations and development is not good. Solvency is unstable and subject to sustainable risk. |
| **Bg+**<br>**Bg**<br>**Bg-** | Financial commitment towards short-term and long-term debts is bad. Business is affected by internal and external uncertain factors. There are difficulties in business operations. Solvency is uncertain and subject to high credit risk. |
| **CCCg** | Financial commitment towards short-term and long-term debts is very bad. Business is affected by internal and external uncertain factors. There are difficulties in business operations. Poor solvency with very high credit risk. |
| **CCg** | Financial commitment towards short-term and long-term debts is extremely bad. Business operations are poor. There are very limited positive internal and external factors to support business operation and development. Extremely high credit risk is found. |
| **Cg** | Financial commitment towards short-term and long-term debts is insolvent. Business falls into a vicious circle. Very limited positive internal and external factors are found to support business operations and development in positive cycle. Extremely high credit risk is seen and is near default. |
| **Dg** | Unable to meet financial commitments. Default is confirmed. |

### B. Long-term Credit Rating Outlook

A rating outlook is the medium- and long-term trend of the credit rating of a rated entity. In formulating a rating outlook, CCXAP considers the potential change in economic and commercial factors from a medium- and long-term perspective for a period of 12 to 18 months.

| | |
|---|---|
| **Positive** | Indicates a rating with an ascending trend |
| **Negative** | Indicates a rating with a descending trend |
| **Stable** | Indicates the rating is likely to be stable |

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**China Chengxin (Asia Pacific) Credit Ratings Company Limited**

Address: Suites 805-808, 8/F, Jardine House,
1 Connaught Place, Central, Hong Kong

Website: www.ccxap.com

Email: info@ccxap.com

Tel: +852-2860 7111

Fax: +852-2868 0656