Credit Opinion 29th December 2017

Red Star Macalline Group Corporation Ltd.

Hong Kong

Category:	Corporate Rating
Rating Type:	Solicited Rating
Industry:	Home Improvement and Furniture Shopping Mall Operator
Long-term Credit Rating:	AA_g-
Rating Outlook:	Stable

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Key Indicators

Red Star Macalline Group Corporation Ltd. [1]	2017H1	2016	2015	2014
Total Assets (RMB billion)	91.1	81.5	73.8	63.9
Total Assets (USD billion) [2]	13.5	11.8	11.4	10.4
Net Assets (RMB billion)	42.1	39.9	38.2	31.4
Net Assets (USD billion) [2]	6.2	5.8	5.9	5.1
Total Revenue (RMB billion)	5.1	9.4	9.2	8.3
Total Revenue (USD billion) [2]	0.7	1.4	1.4	1.4
Net Profits (RMB billion)	2.2	3.7	3.3	3.5
Net Profits (USD billion) [2]	0.3	0.5	0.5	0.6
EBITDA Margin (%)	68.3	61.0	59.2	69.1
Total Capitalization Ratio (%)	38.2	35.5	31.4	32.7
Net Gearing Ratio (%)	43.5	39.7	30.8	36.7
Total Debt / EBITDA (x)	-	3.8	3.2	2.6
Net Debt / EBITDA (x)	-	2.8	2.2	2.0
EBITDA / Interest (x)	5.3	4.8	4.3	5.4

[1] Consolidated financial statements from 2014 to 2017H1 in accordance with China Accounting Standards for Business Enterprises audited by Deloitte Touche Tohmatsu (LLP).

[2] Exchange rates for 2014 (1 USD = 6.1190 CNY), 2015 (1 USD = 6.4936 CNY), 2016 (1 USD = 6.9370 CNY) and 2017H1 (1 USD = 6.7744 CNY) announced by PBOC

Source: Company data, CCXAP research

Rating Drivers

- Leading market position in home improvement and furnishings industry
- Nationwide geographic coverage
- Growing operating scale supported by two-pronged business model
- Steady revenue growth and relatively strong profitability
- Manageable credit metrics with good funding capability and strong liquidity profile
- Sizable restricted assets and capital expenditure

Rating Rationale

The AA_g- rating of Red Star Macalline Group Corporation Ltd. ("RSM" or the "Company") is underpinned by the Company's (1) solid market position in Mainland China with reputable brand name; (2) improvement of geographic and service diversification; (3) growing operating scale supported by two-pronged business model; and (4) adequate liquidity buffer. However, the rating is also constrained by (1) the volatile business nature of China's property market which may affect the retail market of chain home improvement; (2) the Company's sizable restricted assets; (3) large investment scale in self-constructed shopping mall projects; and (4) rapid expansion of managed shopping malls which exerts pressure on management capability.

Rating Outlook

The stable outlook reflects our expectation that RSM will continue to be the market leader in chain home-improvement retail mall sector, benefitting from strong home refurbishment demand and rising number of home buyers. The Company is expected to generate steady earnings and cash flows from its mall business.

What could upgrade the rating?

The rating could be upgraded if the Company (1) improves its market share in home improvement retail mall sector in Mainland China; (2) achieves a track record of enhancing profitability; and (3) improves its credit metrics, such as decrease in debt level and debt leverage.

What could downgrade the rating?

The rating could be downgraded if the Company's (1) profitability deteriorates obviously; (2) credit metrics worsen than anticipated; or (3) liquidity weakens significantly.

Corporate Profile

RSM was founded in 2007 and was listed on the Main Board of The Stock Exchange of Hong Kong (Stock Code: 1528) in June 2015. As of 30 June 2017, Mr. Che Jianxing was the controlling shareholder of the Company who indirectly held 62.96% of the issued shares.

RSM mainly engages in the management and operation of home improvement and furnishings shopping malls, offering comprehensive services to its customers in 150 cities and 28 provinces in mainland China. The Company also involves internet home decoration platform, online retailing, as well as logistics and product delivery services across the country.

As of 30 June 2017, RSM reported consolidated total assets of RMB 91.1 billion and total equity of RMB 42.1 billion. For the six months ended 30 June 2017, RSM generated total revenue of RMB 5.1 billion and net profit of RMB 2.2 billion.

Detailed Rating Considerations

1. Rapid expansion of home improvement and furnishings retail market with intensive market competition

Benefited from ongoing increase in consumer demand and national disposable income, the demand of home building materials and products grew strongly, which leaded to rapid growth in retail sales of chain home improvement and furnishings as well. In 2016, according to the statistics of the National Bureau of Statistics, the accumulative value of retail sales of furniture category, construction and decoration material categories grew by 14.0% YoY. According to the statistics of Frost & Sullivan, the retail sales of the home improvement and furnishings retail market increased by 9.4% YoY to RMB 2.6 trillion in 2016, and the expected CAGR will be 11.1% in the coming five years.

However, rivalry has come of age as competition in China’s home improvement and furnishings market grew stronger. Home building materials and furniture production enterprises in China have indicated less concentrated than in other retail industries where a number of small and medium-sized enterprises operating business with high dispersity across the country. Thus, the operators were keen to develop a reputable brand name and provide premium services so as to attract customers’ stickiness and outperform the competitors. After years of market development and integration, companies with strong background in project management and sufficient scale became the market leaders like RSM, Easyhome, Jeshing Group and B&Q.

In addition, the newly online business model like “Internet-based home improvement” and the growing pressure on increasing operation cost have become big challenges to the traditional home building materials mall operators. The online sales procedure was relatively easier and more convenient in practice, since it has simplified the original buying process and increased efficiency in production management for producers. The cost and channel advantages of “Internet-based home improvement” model fascinated a number of online commercial giants entering into the sector such as JD, Taobao and Tmall.

We expect that the market competition will be more intense. The operators who successfully apply with the new “internet plus” business model will gain continuously benefit in the new business cycle.

2. Leading market position in home improvement and furniture mall business

RSM is a leading home improvement and furnishings shopping mall operator in Mainland China, which mainly offers comprehensive services to the merchants, retail consumers and other business partners in the sector. RSM has the largest market share in the industry in terms of retail sales in 2016, achieved 4.5% of China’s mall sector market share and 11.8% market share in the chain home improvement and furnishings retail mall sector. As of 30 June 2017, the Company operated 214 shopping malls and offered over 1,900 brands in total in its shopping malls.

RSM also ranks first in the China’s home improvement and furnishings retail industry in terms of its operational premises area, number of operating shopping malls and geographic diversification. The Company engages in operation and management of both portfolio shopping malls and managed shopping malls under the brand name of "Red Star Macalline". The leading market position further strengthened by its successful application of "internet plus" business model, such as internet home decoration and internet retailing services, creating a synergy between its offline and online selling platforms. As of mid-2017, the Company's online decoration platform has signed co-operation agreement with 218 decoration parties, and there are 7,224 merchants signed up for RSM's online retail platform.

Along with growing people's disposable income, standard of living, and higher requirement in housing quality, the home improvement and furnishings market in China has expanded rapidly in recent years. Such market demand was expected to increase continuously in the near future. We expected that RSM will maintain its market leading position in the home improvement and furnishings industry by its strong competitive strength.

3. Strategic market presence with nationwide geographic diversification

With nationwide business coverage across mainland China, RSM captures the growth opportunities in the home improvement and furnishings market and diminishes geographic concentration risk. As of 30 June 2017, RSM operated 214 shopping malls in 150 cities of 28 provinces, municipalities, and autonomous regions across Mainland China with total operating area of approximately 13.3 million sqm, including portfolio shopping malls (self-owned or leased) and managed shopping malls (managed under contracts).

Exhibit 1. Number of shopping malls and operating area as of 30 June 2017

Region (Municipality Administrative Region)	No. of portfolio shopping malls	Operating area (sqm)	No. of managed shopping malls	Operating area (sqm)
Beijing-Shanghai-Tianjin-Chongqing	19	1,586,891	4	185,352
Northeast China	10	804,146	9	443,122
North China (excluding Beijing and Tianjin)	6	330,189	21	1,238,499
East China (excluding Shanghai)	17	1,379,807	74	4,051,118
Central China	8	684,060	13	666,262
South China	4	235,790	5	305,775
Northwest China	1	66,006	8	490,743
Southwest China (excluding Chongqing)	4	240,865	11	587,866
Total	**69**	**5,327,755**	**145**	**7,968,737**

Source: Company data, CCXAP research

In line with RSM's business strategy, the Company continued to expand its portfolio shopping malls in tier-one and tier-two cities in recent years, especially in municipalities. As of 30 June 2017, the number of portfolio shopping malls located in municipalities of Beijing, Tianjin, Shanghai and Chongqing recorded 19 with total operating area of approximately 1.6 million sqm, representing 27.5% and 29.8% of the total number and total operating area of the portfolio shopping malls respectively. In terms of regional breakdown, the number of portfolio shopping malls located in East China (excluding Shanghai) and Northeast China recorded was 17 and 10, representing 24.6% and

14.5% of the total number of portfolio shopping malls, respectively. The rest of portfolio shopping malls were mainly located in tier-one and tier-two cities in North China (excluding Beijing and Tianjin), Central China, South China, Northwest China and Southwest China (excluding Chongqing).

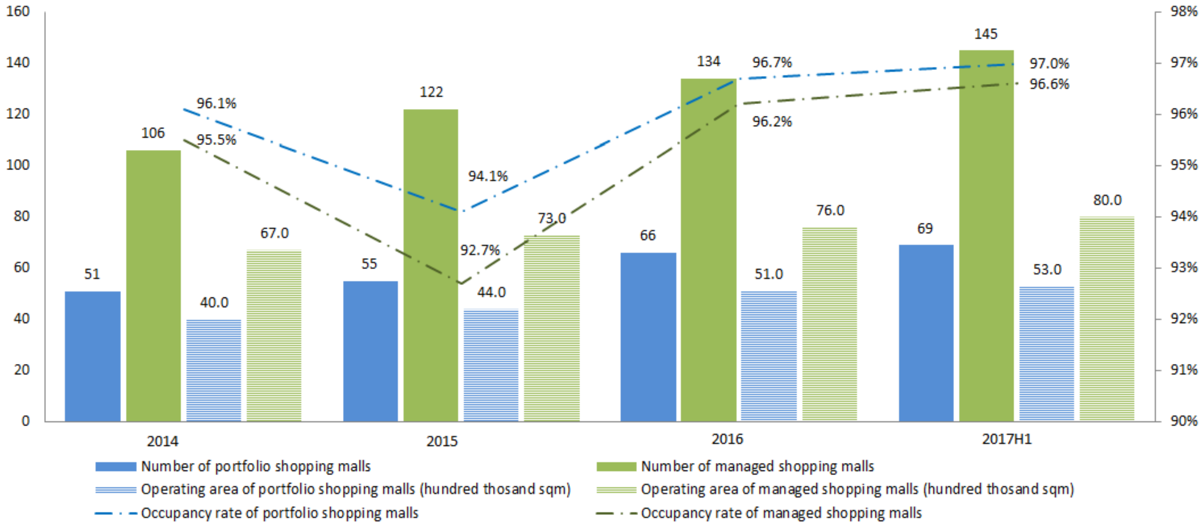
With its reputable branding and enriched experience in shopping mall management, RSM gradually developed a diversified managed shopping mall portfolio mainly in tier-three and lower tier cities. As of 30 June 2017, RSM had 145 managed shopping malls in operation, with a total operating area of 8.0 million sqm. In terms of regional breakdown, 95 managed shopping malls were located in East China (excluding Shanghai) and North China (excluding Beijing, Tianjin), representing 65.5% of the total number of managed shopping malls. The rest 50 managed shopping malls were located in Beijing-Shanghai-Tianjin-Chongqing, Northeast China, Central China, South China, Northwest China and Southwest China, with a nationwide coverage.

In 2016, RSM newly opened 20 managed shopping malls across China and closed 5 managed shopping malls in Liuzhou, Wenzhou, Ningbo, Zhongshan and Laiyang. In 2017H1, the Company newly opened 12 managed shopping malls and one managed shopping malls converted to portfolio shopping mall. There is no shop closed in the first six months of 2017. The Company is expected to adhere to the strategy by focusing on holding portfolio shopping malls in tier-one and tier-two cities, and accelerating the expansion of managed shopping malls in tier-three cities in the future.

4. Growing operating scale underpinned by two-pronged business model and reputable brand name

RSM continued to expand its shopping mall business by its two-pronged business model. The Company especially accelerated the development pace in asset-light business model in order to alleviate the capital expenditure pressure from intensive property investment. As of 30 June 2017, The Company operated 69 portfolio shopping malls and 145 managed shopping malls nationwide, comparing with that of 66 and 134 at end-2016.

Exhibit 2. Number of malls, operating area, and occupancy rate by types of shopping malls



Source: Company data, CCXAP research

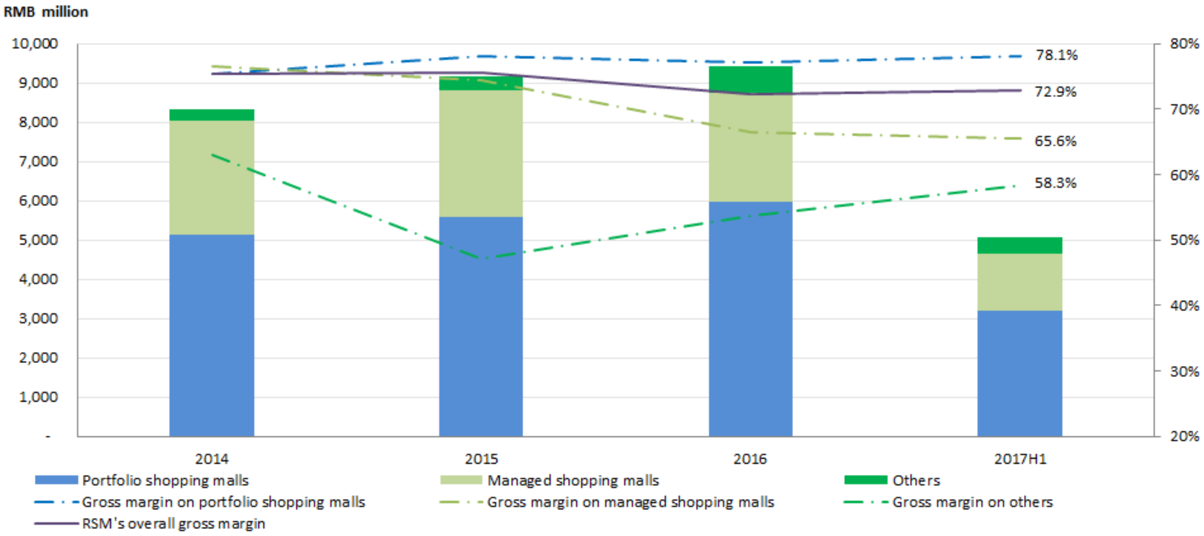
Albeit the ongoing expansion in recent years, the Company kept a high level of average occupancy rate given its good management skills and operation experience. The number of portfolio shopping malls and the number of managed shopping malls grew rapidly in past years. The number of portfolio shopping malls grew to 69 at mid-2017 from 51 in 2014. The number of managed shopping malls grew to 145 at mid-2017 from 106 in 2014. The operating area in portfolio shopping malls grew by 1.3 million sqm to 5.3 at mid-2017 from 4.0 million sqm in 2014. The operating area in managed shopping malls grew by 1.3 million sqm to 8.0 million sqm at mid-2017 from 6.7 million sqm in 2014. In 2017H1, the average occupancy rate in the Company's shopping malls achieved the new highest record, reported 97.0% in portfolio shopping malls and 96.6% in managed shopping malls. In addition, the general average renewal rate of portfolio and managed shopping malls was over 80.0%.

5. Steady revenue growth and relatively strong profitability

RSM maintained a strong profitability and steady revenue growth in recent years. The Company achieved total revenue of RMB 5.1 billion in the first half of 2017, as compared to RMB 9.4 billion in 2016, RMB 9.2 billion in 2015 and RMB 8.3 billion in 2014, with CAGR of 4.2% in total revenue.

The RSM's revenue mainly came from its shopping malls business. Revenue from portfolio shopping malls reported RMB 6.0 billion in 2016, RMB 5.6 billion in 2015, RMB 5.1 billion in 2014, accounted for 63.3%, 60.8%, 61.8% of total revenue, respectively. Revenue from managed shopping malls reported RMB 2.8 billion in 2016, RMB 3.2 billion in 2015, RMB 2.9 billion in 2014, accounted for 29.5%, 35.2%, 34.5% of total revenue, respectively. In 2017H1, the Company generated RMB 3.2 billion from portfolio shopping malls and RMB 1.5 billion from managed shopping malls, accounted for 62.9% and 29.0%, respectively.

Exhibit 3. Revenue breakdown and gross margin by segments



Source: Company data, CCXAP research

The Company's overall gross profit margin retained high in recent years, reported 72.9% in 2017H1, as compared to 72.3% in 2016, 75.6% in 2015, and 75.4% in 2014. The EBITDA margin was 68.3% in 2017H1, as compared to 61.0% in 2016, 59.2% in 2015, and 69.1% in 2014.

The slight decrease in overall gross profit margin was mainly due to the decrease in profit margin on managed shopping malls and other revenue (including sales of merchandise and related services segment) where the intensive competition exerted a downward pressure in the market. In terms of segmental breakdown, the gross profit margin of the portfolio shopping malls slightly increased to 78.1% in 2017H1 from 75.4% in 2014, while the gross profit margin of managed shopping malls declined to 65.6% in 2017H1 from 76.6% in 2014, as a result of the decrease in revenue from contraction, consultation and management fees. We believe that RSM will continue to achieve steady growth in revenue and sustain strong profitability driven by its leading market position, reputable brand name and customer loyalty.

However, there was a large proportion of the profit margin contributed by the change in fair value of investment properties, which may result in vulnerable profit metrics in relation to property market fluctuations. If removing the effect of change in fair value, the adjusted EBITDA margin would be 49.4% in 2017H1, 42.4% in 2016, 48.2% in 2015, and 46.7% in 2014.

6. Accelerating business expansion exerts pressure on capital expenditure and management capability

The shopping mall sector, especially in portfolio malls business model, required an extended return period and high initial investment, leading to a large amount of capital expenditure. The fast expansion also correlated with high pressure on the Company's management capability from increasing numbers of operating shopping malls.

As of 30 June 2017, RSM had 6 portfolio shopping malls under construction with total investment amount of RMB 6.2 billion, while the invested amount recorded RMB 3.5 billion and additional investment amount of RMB 2.7 billion were needed. In October 2017, the Harbin Songbei mall has gone into operation. As of 30 June 2017, the Company had 4 portfolio mall projects and 3 logistic projects under planning with total investment amount of RMB 3.3 billion, while the invested amount and required investment amount needed was RMB 0.6 billion and 2.7 billion, respectively. In August 2017, the Company started the construction of Chengdu Tianfu Avenue project. Moreover, RSM had 354 pipeline managed shopping malls projects under contracted as of 30 June 2017, which has already obtained land licenses from the related institutions.

Exhibit 4. Projects under construction as of 30 June 2017

Projects	Planned GFA (thousand sqm)	Total investment amount (RMB million)	Invested amount (RMB million)	Additional investment amount needed (RMB million)
Nanjing Pukou	248.3	1,100	813	287
Harbin Songbei	182.0	1,000	869	131
Tianjin Binhai	148.4	872	795	77
Wulumuqi Exhibition Mall	187.9	885	525	360
Chengdu Jiannan Avenue Mall	392.0	1,600	262	1,338
Xining Exhibition Mall	120.5	700	229	471
Total	**1,279.2**	**6,157**	**3,493**	**2,664**

Source: Company data, CCXAP Research

Exhibit 5. Projects under planning as of 30 June 2017

Projects	Planned GFA (thousand sqm)	Total investment amount (RMB million)	Invested amount (RMB million)	Additional investment amount needed (RMB million)
Changsha Kaifu	160.0	748	9	739
Changsha Jin Xia	116.0	600	123	477
Chengdu Tianfu Avenue Mall	144.1	678	89	589
Kunming Panlong Mall	166.0	960	308	652
Anhui Teng Hui Warehouse Logistics Center Phase II	19.2	71	35	36
Hefei Red Star Furniture Smart Logistics Base Phase I	44.3	122	38	84
Tianjin Red Star E-commerce Logistics & Settlement Center	89.0	151	51	100
Total	**738.6**	**3,330**	**652**	**2,678**

Source: Company data, CCXAP Research

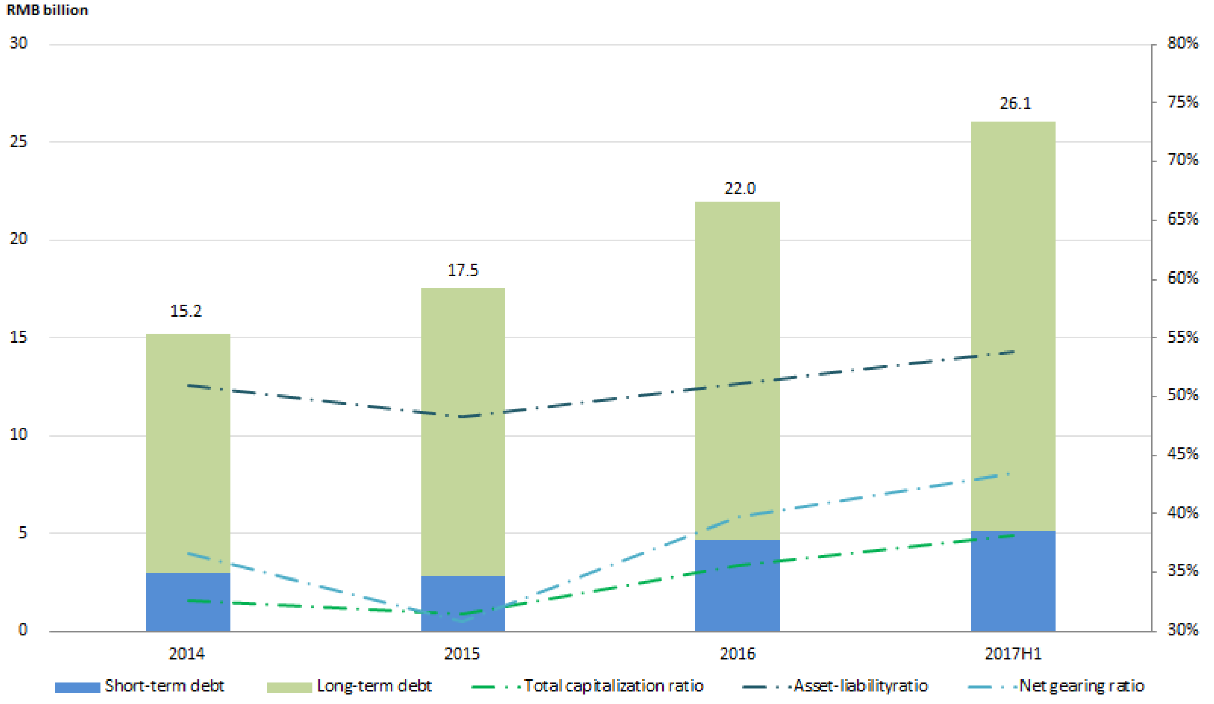
According to current RSM's A share IPO application disclosure, the Company planned to use the new funding to invest RMB 0.5 billion in online decoration platform, RMB 1.5 billion in portfolio shopping malls, RMB 0.6 billion in logistics system upgrade, and RMB 0.3 billion in home decoration.

In addition, given that RSM provides wide-ranging services to its customers wholly by the Company's managerial personnel, the speedy business expansion may cause deterioration in quality of services and give stress on the Company management capability. The quicker development on the project expansions may also exert certain pressure on its capital management and financing capability in the future.

7. Manageable credit metrics with good funding capability

Even the recent rapid business expansion, RSM demonstrated manageable debt leverage and strong interest coverage. The asset-liability ratio reported 53.8% at mid-2017, as compared to 51.0% in 2016, 48.3% in 2015, and 50.9% in 2014. As of 30 June 2017, the total debt grew to RMB 26.1 billion, as compared to RMB 22.0 billion at end-2016. The total capitalization ratio, as measured by total debt to total capital, had an increasing trend over the past years, slightly increased to 38.2% at mid-2017, as compared to 35.5% in 2016, 31.4% in 2015, and 32.7% in 2014. The leverage was believed within a reasonable level. The net gearing ratio, as measured by net debt to total equity, slightly increased to 43.5% at mid-2017, as compared to 39.7% in 2016, 30.8% in 2015, and 36.7% in 2014.

Exhibit 6. Leverage ratios, long-term and short-term debt



Source: Company data, CCXAP Research

We noted that debt repayment of RMB 5.2 billion will be matured within one year, equivalent to 19.9% of total debt at mid-2017, which was considered manageable. In addition, total debt to EBITDA ratio increased to 3.8x in 2016 as compared to 3.2x in 2015, and 2.6x in 2014. The EBITDA interest coverage ratio, as measure by EBITDA over interest expense and capitalized interest, was 4.8x in 2016, as compared to 4.3x in 2015, and 5.4x in 2014. If excluding the change in fair value of investment properties from EBITDA, total debt to EBITDA ratio would be 5.5x in 2016, 4.0x in 2015, and 3.9x in 2014, while EBITDA interest coverage ratio would be 3.3x in 2016, 3.5x in 2015, and 3.7x in 2014.

RSM has also demonstrated good funding capability in onshore debt capital markets by directly issuing various bond types, such as corporate bonds, private placement notes and medium notes with a total amount of RMB 10.3 billion at end-2016. Average borrowing cost was reduced to 5.0% in 2017H1 from 5.4% in 2016. The Company's A share IPO which has been approved by the China Securities Regulatory Commission in December 2017, if successful, will help strengthen the Company's credit profile. The Company planned to use an amount of RMB 0.8 billion in the proceeds of the IPO for repayment of its bank loan. We expect the Company will continue to adopt a good financial policy aiming at maintaining a healthy capital structure.

CCXAP noted the recent revaluation on investment properties by the Company for fulfilling the regulatory requirements in A share IPO. By adopting the new valuation method, some asset items such as investment properties and total assets decreased in comparison with that of end-2016. We will keep tracking on the stability of the capital structure, financial capability and profitability in order to monitor the change of the Company's credit profile.

8. Good liquidity buffer but sizable restricted assets

RSM has a good liquidity management. As of 30 June 2017, the Company's cash reserve was approximately RMB 7.8 billion as compared with RMB 6.1 billion in 2016. The liquidity ratio measured by cash over short-term debt was 1.5x at mid-2017. The net cash generated from operating activities increased to RMB 4.0 billion in 2016 from RMB 3.4 billion in 2015. The Company has also maintained a good relationship with various banks including Industrial and Commercial Bank of China, Bank of China, Development Bank of Singapore and etc. As of 30 June 2017, the available credit facilities balance amounted to RMB 5.5 billion, representing 20.9% of total limit of RMB 26.3 billion.

However, the scale of restricted assets was relatively large. As of 30 June 2017, the restricted assets amounted to RMB 53.9 billion, representing 59.1% of total assets, including cash and cash equivalent of RMB 349.0 million, investment real estate of RMB 53.0 billion, and long-term equity investment of RMB 578.4 million. The sizable restriction in investment properties was caused by the Company's mortgage loan. The long-term equity investments were used as pledging, mortgage and guarantee to related parties. The sizable restricted assets might cause a certain negative impact on the Company's liquidity profile when additional financing was required.

As of 30 June 2017, the external guarantee amount of the Company was RMB 0.3 billion, representing 0.8% of net assets. The guaranteed companies were mainly the joint venture companies and associates companies, thus the risk was expected to be controllable.

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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+ **AAg** **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+ **Ag** **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+ **BBBg** **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+ **BBg** **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+ **Bg** **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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