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# Sunac China: Rapid Growth Through Debt-financed Acquisitions





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Founded in 2003, Hong Kong-listed Sunac China Holdings Ltd. has achieved meteoric growth over the past decade to become one of the country's largest residential property developers. The company rapidly expanded in an era when a diminished supply of attractive properties, rising project development costs, and intense competition with existing developers, stacked the odds against the birth of new real estate giants.<sup>1</sup> But Sunac grew by eschewing the standard real estate growth model of taking out large bank loans to fund pricey plot purchases at city auctions. Instead, Sunac focused on acquiring projects through secondary channels using debt financing raised in the capital markets. The strategy paid off. Sunac amassed a national land bank at below market prices in cities where home price appreciation continues to promise major potential gains.<sup>2</sup>

To be sure, Sunac is not the first real estate developer to come up with a growth strategy that avoids highly competitive primary land sales markets. Executing secondary market transactions, however, is not easy. It requires a mix of strategic boldness, financial acumen, and sales and marketing know-how. Understanding how this latecomer brought these elements together while managing the risks inherent in real estate deal-making helps shed a light on this differentiated growth strategy and its potential in a changing real estate market — one that is increasingly defined by a

heightened regulatory scrutiny of debt and reduced profitability.

## Sunac: Rising from the Ashes

Even in an industry with many outsized personalities, Sunac's Sun Hongbin is a real estate tycoon known for his comeback stories and large appetite for risk-taking.<sup>3</sup> Before going into real estate, Sun Hongbin worked under Liu Chuanzhi, founder of Lenovo, China's flagship computer manufacturer. Rising up the ranks during Lenovo's early days, Sun was once considered

<sup>1</sup> CapitalIQ; \$15.45B at current HKD/USD market exchange rates. Note that not all of Sunac's holdings are on the balance sheet of the listed co. and that market capitalization includes non-free float shares.

<sup>2</sup> See “龙头房企打响排位战：融创成为最大黑马” <https://finance.qq.com/a/20171102/024845.htm>, “‘黑马’融创中国逼近房企三甲” <https://cq.focus.cn/zixun/4c9e384175e904cf.html> for this common characterization of the company in the Chinese financial media.

<sup>3</sup> “A Life with Ups-and-downs: The Journey of a Pragmatic Man.” Sun Hongbin. August 03, 2017. April 10, 2018. <http://finance.sina.com.cn/roll/2017-08-04/doc-ifyjsw-pt5212300.shtml?source=cj&dv=1>.

a possible successor to Liu. However, a falling out with Liu and a checkered legal record, including a stint in a Beijing jail, forced Sun to look for opportunities elsewhere.

But by the time Sun launched his first real estate venture in the mid-1990s, he was able to turn to Liu for funding. Sun grew his venture, Sunco, from a small real estate agency to one of Northern China's largest integrated developers. About a decade later, high gearing and an overstretched balance sheet brought the firm to the brink of collapse amid a round of property price cooling measures implemented by the central government. Sun was forced to sell Sunco at a significant discount to Hong Kong investors.<sup>4</sup> From this experience, Sun later claimed to have learned two valuable lessons: (a) avoid blind bidding competitions for land parcels and (b) maintain operational discipline to support high gearing with rapid sales turnover.

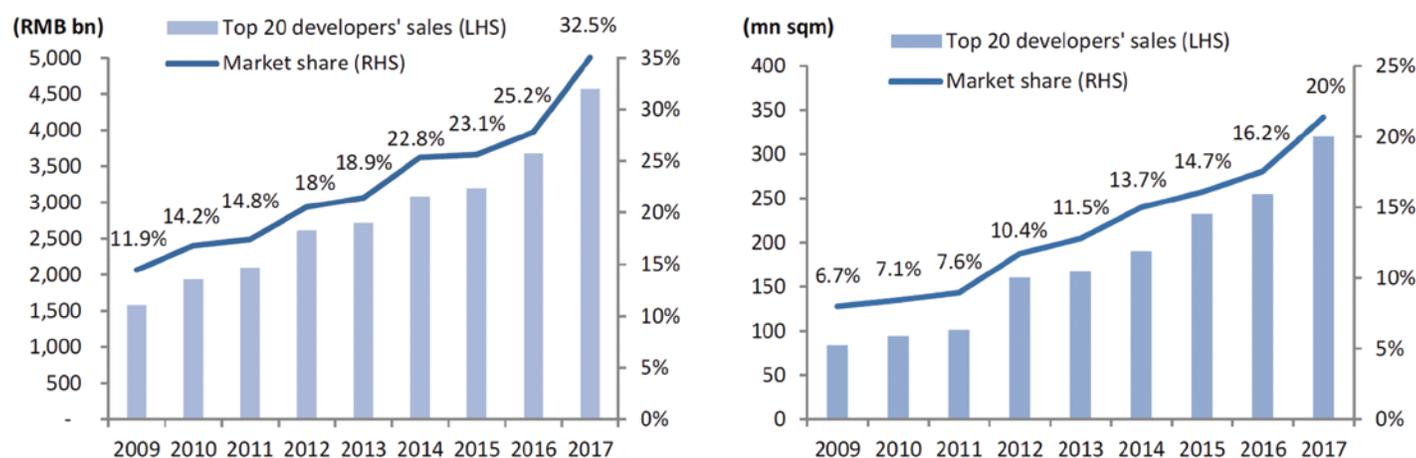
Not surprisingly, Sun did not give up. In 2003, he reorganized his assets under the Sunac brand, this time confronting a real estate market even less inviting

to newcomers but perhaps particularly suited to the aggressive growth strategy that Sun had honed over two decades. Sunac's IPO on the Hong Kong Stock Exchange in 2010 only fueled Sunac's strategy — aggressively making highly leveraged acquisitions in the secondary market.

## Real Estate Industry: Soaring Prices and Cooling Measures

China's decade of unrestrained real estate market growth in the 2000s had a day of reckoning. Developers faced skyrocketing land prices, tightened land supply, and also a surprise move by monetary authorities to institute market 'cooling' measures through mortgage lending caps for consumers. These challenges became increasingly problematic for developers that wanted to expand in Tier 1 and 2 cities. By 2014, the land supply in Tier 1 and 2 cities had dropped by 40% from their peak. Local governments in Shanghai, Beijing, and Hangzhou carefully rationed out land parcels at a significant premium to protect fiscal income; land prices in major

Figure 1 - Consolidation in Chinese real estate



Source: Deutsche Bank, CRIC, CEIC, ShenChuang

4 See “孙宏斌——一人饰双雄，几经沉浮的地产狂人” [http://www.sohu.com/a/165301122\\_525418](http://www.sohu.com/a/165301122_525418)

cities rose by 15-fold in less than 10 years (Exhibit 1)<sup>5</sup>. Expensive land parcels and restricted consumer financing forced developers to explore new avenues in growing their land bank beyond primary markets.

Increased capital requirements and the need for improved risk tolerance fed into the market's rapid consolidation, with larger developers often acquiring smaller players. From 2009 to 2017, the top 20 national developers nearly tripled their share of annual property sales from less than 12% to more than 30%.<sup>6</sup> Moreover, China's top developers had remained unchallenged by new entrants since 2010: The 15 largest developers of that year were on the list of China's 20 largest developers in 2017.<sup>7</sup> Getting squeezed out of the market were smaller developers without financing or scale, and a large number of them became acquisition targets.

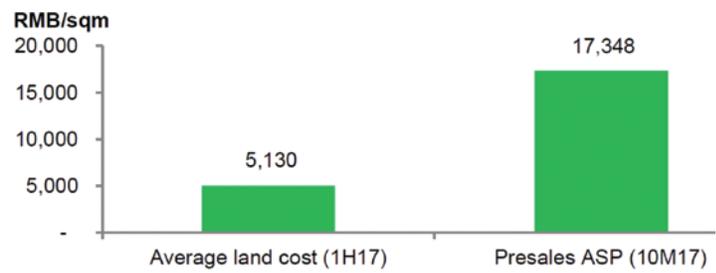
## Sunac: Nimble and Acquisitive

Long before Sunac's rise, analysts had predicted that acquiring distressed developers would become the next avenue for growth in real estate. China's long tail of 130,000 real estate companies seemed like a natural target.<sup>8</sup> However, deeply local markets, complex due diligence, and fiercely founder-centric cultures scared off most would-be acquirers. Not Sunac.

While larger real estate players danced around deals, Sunac's smaller, nimbler M&A teams got to work. By 2018, Sunac secured an industry-leading land bank of 100 million square meters. Roughly 70% of this gross floor area came through secondary transactions (Exhibit 2).<sup>9</sup> Thanks to its purchasing spree, Sunac was able to break into the major Chinese cities of Shanghai,

Chengdu, and Chongqing at a significant discount. It acquired land at an average of 5,000 RMB/sqm, or far below the 17,000 RMB/sqm average primary market land auction price.<sup>10</sup>

Figure 2 - Sunac average land costs vs. land auction prices



Source: ABCI Securities

Thanks to its larger land bank, Sunac's sales grew 122% in 2016, followed by an equally staggering 139% in 2017 as other developers struggled to feed their pipelines. With 294 projects underway in 2017, Sunac became one of China's largest real estate players in annual sales (Exhibit 3).

## M&A Philosophy: Selective, Strategic, Swift

Sunac's secret is that its M&A team behaved more like real estate entrepreneurs than private equity investors. Instead of acquiring entire entities, Sunac's team was better known for acquiring struggling individual projects. For example, Sunac acquired a handful of individual projects from Kaisa, CC Land, and Top Spring in order to break into Shanghai, Chongqing, and Shenzhen.<sup>11</sup> Since individual projects required much lower M&A costs and less due diligence, Sunac was able to close its

5 Daniel Fan, Lu Sun, Ryan Li (J.P. Morgan) "China Property: More complexity, more opportunities" November 25, 2016; Wee Liat Lee, Tracy C. Cheng (BNP Paribas) "China Real Estate: Not all rallies will continue in 2018" November 10, 2017

6 Jeffery Gao, Jason Ching, Stephen Cheung, Foo Leung (Deutsche Bank) "China Property: Accelerating consolidation amid slower market in 2018" February 1, 2018

7 "China's Top Selling Real Estate Developers in 2017." April 10, 2018. [http://city.shenchuang.com/city/20180102/755359\\_2.shtml](http://city.shenchuang.com/city/20180102/755359_2.shtml).

8 China Consensus: Real Estate." April 10, 2018. <http://data.stats.gov.cn/normal.htm?u=/files/html/quickSearch/pc/pctz04.html&h=760&tName=按登记注册类型分房地产开发企业法人单位个数>.

9 See Kenneth Tung (Agricultural Bank of China International Securities) "Sunac: A new adage: high gearing for high growth" November 14, 2017; John Lam, Jeffery Zeng, Leif Chang, Sara Wang (Morgan Stanley) "Sunac China Holdings: Substantial earnings growth ahead; initiate at OW" June 29, 2017

10 Kenneth Tung (Agricultural Bank of China International Securities) "Sunac: A new adage: high gearing for high growth" November 14, 2017

11 Yin Xin, "Buying frenzy – Sun Hongbin's Sunac had at least 13 deals in 2016". <http://tech.sina.com.cn/i/2017-07-07/doc-ifyhwehx5351384.shtml>

deals quickly to accelerate sales turnover. Sunac's legal and finance teams were also known to be nimble and resourceful, delivering rapid timelines by targeting each deal at a local level while larger rivals dithered.<sup>12</sup>

At the 2015 annual shareholder meeting, Sun highlighted this purposeful shift from traditional M&A activities: "Acquiring entities is a very painful process: It doesn't make sense for us to buy an entity with five strong projects and five weak projects. Sunac would rather directly negotiate on one location or several projects."

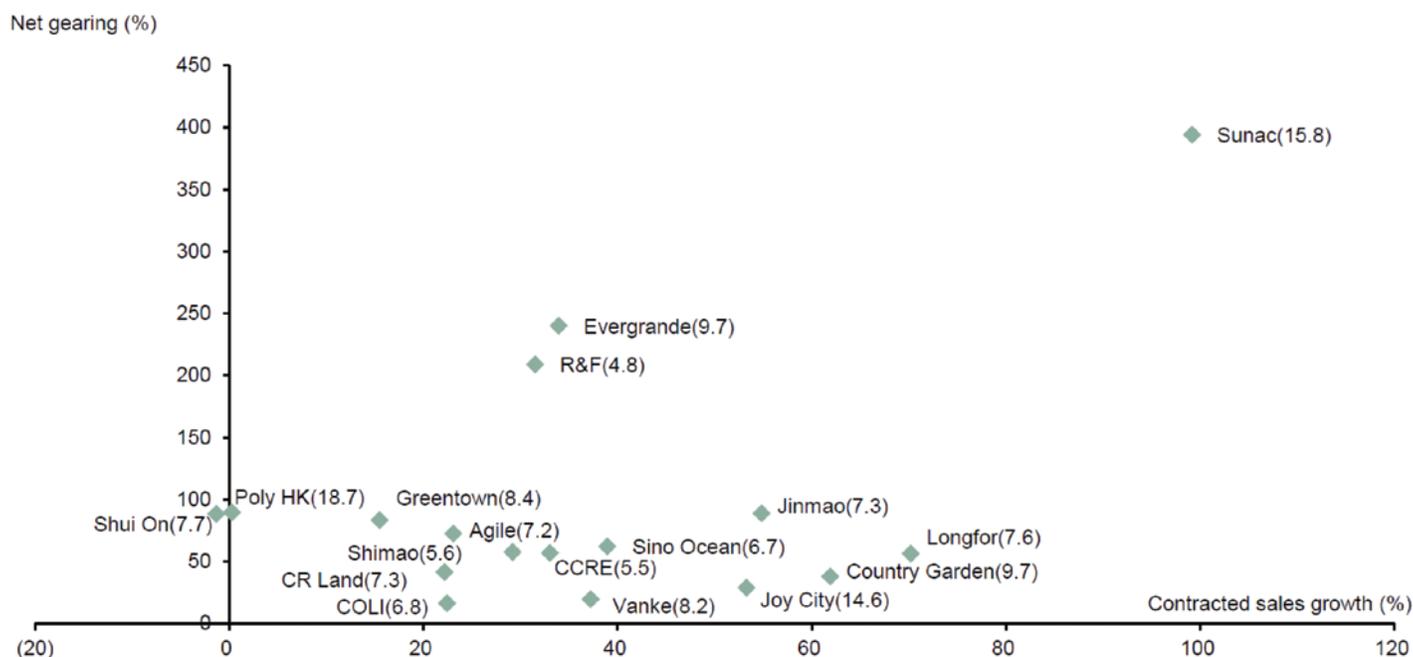
Project-based acquisitions also help Sunac circumvent traditional pitfalls of acquiring whole entities. Traditional M&A increases the complexity, and thus risks, of a transaction. Cultural fit, complicated ownership structure, and entrenched power dynamics threaten the speed and effectiveness of acquisitions. Also, it is highly unlikely that Sunac can consistently acquire companies with the optimal geographic and pricing of projects. Finally,

traditional M&A will warrant much higher prices, risking the need for regulatory approval.

Sunac's teams are also famous for creating novel deal and ownership structures to facilitate takeovers. For struggling smaller projects, Sunac offers direct equity injection in exchange for direct control. To a rarer extent, Sunac sometimes acts as the exit strategy for large distressed developers through takeovers. The acquisition of Legend Holdings' real estate business in 2016 at US \$1.8 billion is one example.<sup>13</sup>

Sunac also pioneered a joint venture strategy whereby it would inject equity into struggling large developers who were unwilling to sell. In these cases, the combination of a leading developers' local knowledge and Sunac's own aggressive operations and financing tactics have helped to turn struggling projects around. Sunac's JV with Shanghai's Greentown is its most famous example. In 2012, Sunac invested 337 million RMB into Greentown's

**Figure 3 – Sunac's leverage compared to rest of industry**



Source: Company data, Bloomberg consensus (for PE); BNP Paribas estimates (for sales growth)

<sup>12</sup> E-House research material, unpublished document

<sup>13</sup> Hu Xiaohong, "Lenovo real estate sold to Sunac" <http://tech.sina.com.cn/it/2016-09-20/doc-ixvykww5203056.shtml>

nine Shanghai projects. This partnership blossomed into dozens of collaborations yielding over 1 billion RMB in annual sales, and reflected Sunac's ability to marry its finance and operation disciplines with Greentown's eye for quality land parcels.<sup>14</sup>

All in all, Sunac's M&A philosophy extends beyond the deal closure. Sunac is well-known for its emphasis on drive and execution, which it brings to its partnerships. Indeed, Sunac's own career site emphasizes that the company expects "duty-like" passion on the part of its employees. Employees are measured by high-pressure KPIs to deliver on both individual and team levels<sup>15</sup>. But Sun's aggressive management style and emphasis on rapid project turnover have caused some conflict with major JV partners and potential takeover targets. For example, proposed full acquisitions of both Greentown and Kaisa became hostile and later failed amid reported accusations that Sunac had a 'corporate raider' attitude.<sup>16</sup>

## Financing: Industry-leading Risk Tolerance

Despite some shortcomings, Sunac nonetheless is lauded in the real estate industry for its ability to learn from mistakes in an all-out pursuit of growth, which has helped to excuse the company's occasional bumpy execution. Industry analysts have commended Sunac's strategy. In 2017, Deutsche Bank rated Sunac as a "Buy," citing its robust land bank as a major growth engine for years to come.<sup>17</sup> But success comes at a cost. Sunac has the most levered financial structure

amongst the industry's major players. Its net gearing, defined as debt obligations over equity, comes in at more than 400%, far higher than the industry average. Moody's gave Sunac a below-investment grade credit rating of B3 with a negative outlook, warning that its current cash-flow is extremely stressed under the company's growing leverage.<sup>18</sup>

To Sunac's credit, its management team has taken steps to optimize borrowing costs and risks under this levered strategy. As Sunac grew, management began shifting from bank loans to corporate bonds and other securities. It also refinanced its short-term loans with a combination of nimble onshore and offshore debt issuance to manage interest payments. Sunac's weighted average cost of capital, in turn, has declined from 10% in 2013 to 6% in 2016, with new borrowing costs hovering at 5.8% in 2016.<sup>19</sup> All this points to Sunac management's awareness of potential liquidity issues coming up.

Sunac's buying spree continues. The company grabbed national headlines in 2017 with its landmark acquisition of Wanda's theme parks and hotel portfolio for \$6.5 billion.<sup>20</sup> While some Sunac investors noted that the company acquired this extensive footprint at below-market rates, others worry that its cash on hand after the deal may be less than its short-term debt obligations.<sup>21</sup>

## Risks and Challenges Ahead

Sunac took a different development path than the real estate industry's first movers and succeeded. Nonetheless, the company's path forward likely requires further adaptations in response to tightening regulations

14 "Sunac Greentown: Over 10B RMB Sales in Shanghai with More Potential to Come." April 10, 2018. <http://huaian.leju.com/news/2014-01-16/14233882103.shtml>.

15 "What Is It like Working at Sunac?" April 10, 2018. <https://zhuanlan.zhihu.com/p/29333534>.

16 Josh Noble, Patrick McGee, Peter Wells, *Financial Times*, "Sunac terminates plan to acquire Kaisa" May 27, 2015; "Analyzing the battle between Sunac and Greentown." <http://www.ocn.com.cn/chanjing/201411/ronghcuang280901.shtml>

17 "Deutsche Bank Increases Sunac Target Price by 42%." September 04, 2017. Accessed April 10, 2018. <http://finance.sina.com.cn/stock/hkstock/ggscyd/2017-09-04/docifykpzey4224609.shtml>.

18 "Moody's Assigns B3 to Sunac's Proposed USD Notes." August 02, 2017. Accessed April 10, 2018. [https://www.moody.com/research/Moodys-assigns-B3-to-Sunacs-proposed-USD-notes-PR\\_370732](https://www.moody.com/research/Moodys-assigns-B3-to-Sunacs-proposed-USD-notes-PR_370732).

19 Sunac China Investors Relations. April 10, 2018. <http://www.sunac.com.cn/en/relationship.aspx?tags=5>.

20 Shu Zhang, Matthew Miller (Reuters) "Dalian Wanda amends Sunac property deal after China curbs funding" July 19, 2017

21 "Sunac China's Shares Soar as US\$9.3 Billion Wanda Property Deal Seen as Positive." July 11, 2017. April 10, 2018. <https://www.channelnewsasia.com/news/business/sunac-china-s-shares-soar-as-us-9-3-billion-wanda-property-deal-seen-as-positive-9022772>.

and potential partnership conflicts, perhaps owing to clashes in management style. Today, regulators are much more sensitive to deals with heavy debt-financing. When Sunac purchased Wanda's theme park portfolio, regulators attempted to block the deal because of its heavy reliance on debt. In early 2018, China's banking regulators also began blocking M&A deals that are used as a means to raise funding for land purchases.<sup>22</sup>

Given Sunac's preference for leverage as a growth strategy, increased regulatory tightening predicts slower sales turnover, an increase in capital requirements, and additional time needed to navigate regulatory frictions. Sunac's unique leverage risk is also unlikely to disappear in the short-term. Even with Sunac's effort to reduce the cost of capital on its new debt, the market remains skeptical of its ability to repay its obligations. Indeed, Sunac's interim 2017 financial results disclosed that the company's 70 billion RMB cash on hand barely covers its short-term borrowing load of 69 billion RMB.<sup>23</sup> In the first six months of 2017, Sunac's interest expense reached 4.5 billion RMB, four times its profit for the same period.

In addition, there are concerns about Sunac's diversification strategy away from its core residential property business. Issues were first raised in the Wanda deal. Its investment in LeEco, a non-residential real estate company with businesses in online streaming and electric cars, takes Sunac further away from its core competencies.<sup>24</sup> Sun Hongbin's attempt at playing white knight at LeEco by assuming the role of emergency chairman is indicative of Sunac overreaching.

Even in its core business, Sunac's existing acquisition model has some issues. In 2014, Sunac filed to acquire 24% of Greentown, making it one of the largest shareholders. However, within six months, Greentown founder Song Weiping backed out of the deal. Rumors

pointed to a culture clash between Greentown property owners and employees, and Sunac's management style.<sup>25</sup>

## Conclusion

The story of Sunac and its founder Sun Hongbin is an unfinished one. Arguably, Sunac's controversial strategy represents a new school of thought in Chinese real estate. Sunac's aggressive expansion and risk tolerance have brought the company a whole decade of prosperity. To Sun's credit, he has built a nimble, pragmatic organization famed for its effectiveness and speed in locking away lucrative deals in a fairly opaque secondary market. However, as the Chinese real estate market comes under increased regulation and top Chinese players move towards financial discipline in fundraising and risk management, the market can only hold its breath as Sunac's aspirations and its debts continue to rise.

22 "China Urges Crackdown on M&A Loans Used to Buy Land." Bloomberg.com. February 01, 2018. April 10, 2018. <https://www.bloomberg.com/news/articles/2018-02-01/china-is-said-to-urge-crackdown-on-m-a-loans-used-to-buy-land>.

23 Sunac China Investors Relations. April 10, 2018. <http://www.sunac.com.cn/en/relationship.aspx?tags=5>

24 Qu Yunxu, Sun Congying, Wang Xiaoqing, "Sun Hongbin elected as LeEco CEO – How did Jia Yueting lose LeEco?" July 21, 2017; Emily Feng, *Financial Times* "Sunac throws another lifeline to cash-strapped LeEco" November 16, 2017

25 Greentown Sunac Merger Fails After Three Months. April 10, 2018. <http://finance.china.com.cn/industry/special/lcrcllysb/index.shtml>.

## Appendix

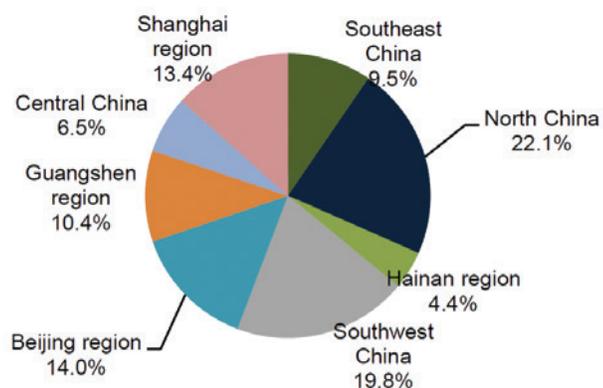
### Exhibit 1: Land Sales

	Land sales volume (GFA, mn sqm)					Land sales value (Rmb bn)					Average land price (on GFA, Rmb psm)				
	Tier 1	Top 2nd	Low 2nd	Tier 3/4	National	Tier 1	Top 2nd	Low 2nd	Tier 3/4	National	Tier 1	Top 2nd	Low 2nd	Tier 3/4	National
2006	38.81	51.38	113.04	96.85	300.07	56.38	83.87	101.58	106.04	347.87	1,453	1,632	899	1,095	1,159
2007	37.60	74.55	144.60	274.14	530.89	100.68	218.49	210.48	274.10	803.74	2,678	2,931	1,456	1,000	1,514
2008	25.92	64.77	120.55	338.71	549.95	82.65	101.48	119.13	231.64	534.90	3,189	1,567	988	684	973
2009	36.11	136.47	245.33	373.31	791.21	198.41	317.02	301.89	315.01	1,132.33	5,495	2,323	1,231	844	1,431
2010	36.97	179.36	351.12	686.51	1,253.97	237.80	462.32	506.74	593.89	1,800.73	6,432	2,578	1,443	865	1,436
2011	35.47	108.74	344.12	713.07	1,201.41	145.90	251.37	491.65	608.70	1,497.62	4,113	2,312	1,429	854	1,247
2012	24.54	127.03	319.91	538.17	1,009.65	115.20	325.19	432.26	486.49	1,359.13	4,695	2,560	1,351	904	1,346
2013	36.04	125.21	410.70	761.05	1,333.00	272.89	448.51	666.64	800.04	2,188.08	7,572	3,582	1,623	1,051	1,641
2014	29.28	102.12	278.59	489.70	899.68	343.82	351.26	440.45	505.56	1,641.09	11,745	3,440	1,581	1,032	1,824
2015	29.56	103.14	204.89	364.90	702.49	339.49	386.43	427.06	429.52	1,582.49	11,485	3,747	2,084	1,177	2,253
10M2016	8.93	89.53	137.98	230.44	466.87	170.96	588.24	511.42	349.48	1,620.09	19,143	6,571	3,707	1,517	3,470
2016E	11.08	121.19	184.40	310.17	626.84	229.15	760.54	672.62	492.87	2,155.19	20,673	6,276	3,648	1,589	3,438
2017E	14.41	145.42	202.84	325.68	688.35	283.01	775.75	665.89	465.77	2,190.41	19,639	5,334	3,283	1,430	3,182

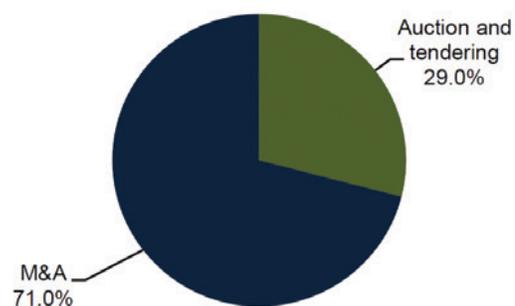
	2014	2015	2016	9M17	2014	2015	2016	9M17
	----- Growth (y-y %) -----							
<b>Land sales value (RMB b)</b>								
Tier 1	343.8	344.2	247.3	268.8	26	0	(28)	60
Tier 2	795.2	831.6	1,508.9	1,208.6	(27)	5	81	19
Tier 3/4	394.4	448.2	520.8	585.8	(37)	14	16	63
<b>Land sales GFA (m sqm)</b>								
Tier 1	29.3	29.8	14.9	16.8	(19)	2	(50)	99
Tier 2	404.3	362.2	360.5	247.1	(26)	(10)	0	1
Tier 3/4	348.7	400.0	348.5	271.0	(33)	15	(13)	8
<b>Land sales AV (RMB/sqm)</b>								
Tier 1	11,745	11,533	16,578	16,019	55	(2)	44	(19)
Tier 2	1,967	2,296	4,185	4,891	(2)	17	82	17
Tier 3/4	1,131	1,120	1,494	2,161	(5)	(1)	33	51

Sources: Deutsche Bank, BNP Paribas, CRIC, CEIC

## Exhibit 2: Sunac Landbank



\*Excluding the Wanda acquisition



\*Excluding the Wanda acquisition

## Exhibit 3: Sunac China Financial and Operating Results

Rmb, bn	2012	2013	2014	2015	2016	2017E
Contract Sales	35.6	54.7	65.8	68.2	150.6	362.0
Revenue	20.8	30.8	25.1	23.0	35.3	103.8*
Gross Profit (Pre-LAT)	5.4	7.2	4.3	2.9	4.9	20.6*
Gross Margin (Pre-LAT)	25.8%	23.3%	17.3%	12.4%	13.7%	19.9%*
Cash and cash equivalents	12.3	16.0	25.0	27.1	69.8	33.5
Net Gearing	78.9%	69.7%	44.5%	75.9%	121.5%	452%*
Overall Weighted Avg. Financing Cost	—	10.0%	9.1%	7.6%	6.0%	—
Weighted Avg Finance Cost for New Borrowings	—	8.3%	7.6%	6.4%	5.8%	—

Sources: Company Annual Report, \*estimates from ABC International analyst's report