

China Hongqiao Group Limited

Surveillance Report

Summary

Issuer Rating	BB+
Outlook	Stable
Location	China
Industry	Metals and Mining
Date	28 May 2021

Operating Data:

China Hongqiao Group Limited

	31 Dec 2019	31 Dec 2020
Revenue (RMB: in million)	84,179	86,145
Reported Gross margin (%)	19.6	22.5
Annual Production Capacity (Tons: in million)	6.46	6.46
Production Volume ⁽¹⁾ (Tons: in million)	6.27	6.24

(1) Production volume includes aluminum alloy products and aluminum fabrication products' output

Lianhe Ratings Global Limited ("Lianhe Global") has upgraded the global scale Long-term Issuer Credit Rating of China Hongqiao Group Limited to 'BB+' from 'BB'; Issuer Rating Outlook Stable.

Summary

The Issuer Rating upgrade to 'BB+' reflects China Hongqiao Group Limited's (1378.HK) ("China Hongqiao" or "the company") demonstrated effort in financial deleveraging, leading market position, economy of scale and vertically integrated production platform providing cost advantage, and improving operating performance. However, China Hongqiao's rating is constrained by its relatively flat growth, regulatory risks, and cyclical industry nature.

Lianhe Global has also upgraded the global scale Long-term Issuance Credit Rating to the senior unsecured USD notes issued by China Hongqiao to 'BB+' from 'BB' at the same time. A full list of issuance ratings is included in this report.

The Issuer Rating Outlook reflects our expectation that China Hongqiao will continue to maintain its operating performance, driven by its leading market position, aluminum industry uptick, economy of scale and cost advantage. We also expect China Hongqiao to remain prudent on its overseas expansion pace with normalized level of capital expenditure, which together with improved operating performance, will help the company to contain good operating cash flow and continue its deleveraging effort.

Rating Rationale

Leading Market Position with Enhanced Cost Advantage and Potential Volume Growth:

China Hongqiao is one of the world's largest aluminum producers which mainly focuses on sales of molten aluminum alloy and alumina primarily in China with an annual production capacity of 6.46 million tons. In response to China's environmental protection policies and to enhance its cost competitiveness, the company is migrating aluminum production capacity of approximately 2,030,000 tons (about one third of its total annual production capacity) to Yunnan Province. Migration of the first one million tons of capacity has been completed with one third (330,000 tons) of production deployed in 1H 2021 already. We expect the remaining of the one million tons of capacity to be deployed in 2H 2021, which could boost China Hongqiao's production volume to grow at c. 5% to c. 6 million tons in 2021 versus 5.7 million tons in 2019 and 2020.

Production volume decreased in 2019 primarily due to the impact of the Chinese government's production restriction during the winter season, the company's replacement of existing production facilities (320KA and 400KA) with more advanced facilities (600KA) and the effects of the rainstorm caused by Typhoon Lekima. The migration of production capacity to Yunnan is expected to remedy for the loss of production volume once capacity is ramped up. Relocation of the remaining 1.03 million tons is expected to commence in late 2021/early 2022.

The new plants in Yunnan will enjoy clean energy resources and lower electricity costs, with supportive policies from the Yunnan Provincial Government. We expect China Hongqiao to incur annual capital expenditure including cost of migration and facilities upgrades at c. RMB5-6 billion in the next 12-24 months.

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Applicable Criteria

[General Corporate Rating Criteria \(16 July 2018\)](#)

Resilient Domestic Industry Dynamics Supporting Aluminum Prices: Demand for aluminum globally has been hit by COVID-19 which suppressed aluminum prices in the overseas markets in 2020. On the other hand, the Chinese government's stimulus initiatives to promote internal consumption and infrastructure constructions have boosted domestic demand for aluminum and related products. The increase in demand, together with the supply-side reform limiting production capacity growth, fueled the increase in aluminum prices domestically since 2H 2020. In 2021, aluminum prices continued the upward trend, increasing from c. RMB15,000 per ton in January to c. RMB19,000 in May, before retreating to c. RMB18,000 level. We expect the industry dynamics will continue to provide certain level of support to aluminum prices in the next 12 months. China Hongqiao generated over 95% of its revenue domestically in China.

Vertically Integrated Production Platform and High Self-sufficiency Rates: China Hongqiao has established a vertically integrated production platform comprising stable supply of bauxite, refinery plants (of bauxite), one of the world's largest alumina smelters with captive power plants, as well as aluminum fabrication plants etc. The vertically integrated production platform enables China Hongqiao to keep costs under control to stay competitive. China Hongqiao has signed long-term contracts with its upstream raw material suppliers and it has also established long-term business relationships with its downstream clients.

China Hongqiao continues to source a majority of bauxite and electricity consumption via its vertically integrated production platform. This high degree of self-sufficiency enables China Hongqiao to keep costs under control through partial insulation from raw materials and electricity price fluctuation to stay competitive. Favorable government policies such as lower power tariffs and access to renewable energy sources in Yunnan are expected to benefit China Hongqiao in maintaining a competitive production cost structure. China Hongqiao has also been investing in upgrading its facilities to meet stricter environmental standard, which could further strengthen the company's competitive positioning in the aluminum industry in China.

China Hongqiao's reported gross margins were 17.1 %, 19.6% and 22.5% in 2018, 2019 and 2020, respectively, demonstrating the company's ability to improve its margin through the industry cycle. Given the strong performance in aluminum prices and the company's cost advantage, we expect China Hongqiao to be able to maintain a reported gross margin level of above 20% in the next 12-24 months.

Demonstrated Effort on Financial Deleveraging; Good Cash Flow Generation and Liquidity: China Hongqiao's financial leverage in terms of debt over EBITDA has shown an improving trend, down from over 4x at end-2018 and end-2019 to 3.6x at end-2020. We believe the company has demonstrated its effort to deleverage and we expect this trend to continue, given its strong cash flow generation capability and low expected capital expenditure spending. We expect China Hongqiao's financial leverage to further improve to 3.0-3.3x in the next 12-24 months.

China Hongqiao's liquidity is good. The company had total cash on hand of RMB47.0 billion (unrestricted cash of RMB45.5 billion) at end-2020, compared with its short-term debt of RMB45.6 billion. China Hongqiao also had unutilized credit facilities of c. RMB20.8 billion at end-2020. We also expect the company to generate c. RMB15-20 billion of operating cash flow per annum in the next 12-24 months, which all together will enable China Hongqiao to meet its financial obligations. China Hongqiao's refinancing capabilities was demonstrated via its utilization of internal resources and various financing means such as equity placements and convertible bond issuances to redeem its matured debt in 1H 2021.

Rating Sensitivities

We would consider downgrading China Hongqiao's rating if it were to increase to its financial leverage as measured by its EBITDA interest coverage consistently below 4.0x or debt over EBITDA leverage consistently above 4.0x, or it suffers a significant deterioration in operating performance in terms of revenue, margin or cash flow generation, or its liquidity is worsened.

We would consider upgrading China Hongqiao's rating if it were to maintain its leading market position and cost advantage, while continue to demonstrate prudent financial management and maintain its financial leverage as measured by its EBITDA interest coverage and debt over EBITDA leverage consistently commensurate with the 'BBB' rating category.

Company Profile

China Hongqiao is a leading large-scale aluminum product manufacturer which mainly focuses on the production and sales of aluminum and aluminum products in China. It was established in 1994 and has been listed on the Hong Kong Stock Exchange (1378.HK) since 2011.

Mr. Zhang Bo, chairman of the board, together with the Zhang's family, was the largest shareholder and held c. 68.5% stake of China Hongqiao through Trust Company at end-2020. Following the completion of the equity placement on March 19, 2021, Zhang's family held c. 66.7% of China Hongqiao. CITIC Limited continued to be the strategic cooperater of China Hongqiao and was the second largest shareholder holding c. 9.6% of China Hongqiao.

China Hongqiao's Shareholder Structure at end-March 2021

Shareholder	Percentage
Hongqiao Holdings ⁽¹⁾	66.6%
Mr. Zhang Bo	0.1%
CTI Capital Management Limited ⁽²⁾	8.8%
CNCB (Hong Kong) Investment Limited ⁽²⁾	0.8%
Other Public Shareholders	23.7%
Total	100.00%

(1) Wholly owned by a trustee who holds such interests in shares on behalf of the Zhang's Family

(2) Direct or indirect subsidiaries of CITIC Group Corporation

Source: China Hongqiao

Key Financial Assumptions

- Production capacity: 6.46 million tons for 2021-2023
- Aluminum price: c. RMB17,000-18,000 per ton
- Capital expenditure: c. RMB5-6 billion per annum
- Production volume: c. 5% growth in 2021 and normalized in 2022-2023

Key Financial Metrics

2019A-2023F	Debt/EBITDA	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Avg	3.4x	4.6x	47.2%	0.87x

Source: China Hongqiao's annual reports and Lianhe Global's adjustments and forecasts

Full List of Issuance Ratings

A full list of affirmed issuance ratings is included below. Any action on China Hongqiao's rating would result in a similar rating action on its USD notes:



- USD300 million 7.125% senior unsecured notes due 2022 upgraded to 'BB+' from 'BB'
- USD200 million 7.375% senior unsecured notes due 2023 upgraded to 'BB+' from 'BB'

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