Jiangsu Shagang (Group) Company Limited

Initial Issuer Report

Lianhe Ratings Global Limited ("Lianhe Global") has assigned 'BBB+' global scale Long-term Issuer Credit Rating to Jiangsu Shagang (Group) Company Limited; Outlook is Stable

Summary	
Issuer Rating	BBB+
Outlook	Stable
Location	China
Industry	Steel
Date	22 June 2021

Operating Data:
Jiangsu Shagang (Group) Company Limited

	31 Dec 2019	31 Dec 2020
Total Revenue (RMB: in million)	144,231	152,911
Production Capacity[1] (Tonnes: in million)	76	76
Utilization Rate (Pig Iron)	98.4%	100%
Utilization Rate (Crude Steel)	97.7%	96.7%
Utilization Rates (Steel Products)	98.9%	98.3%

1) Excluding associated companies
Source: Shagang

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Applicable Criteria
General Corporate Rating Criteria (16 July 2018)

Summary

The Issuer Rating reflects Jiangsu Shagang (Group) Company Limited's ("Shagang" or "the company") competitive market position as the largest private steel producer in China, above average operating efficiency and above industry-average utilization rates, and strong operating cash flow. The company's rating is constrained by its low raw materials self-sufficiency which makes it vulnerable to commodity price fluctuations, slow margin growth in key products amid rising raw materials costs, and relatively high yet stabilizing financial leverage in relation to its "BBB" category credit profile.

The Stable Outlook reflects our expectation that Shagang will sustain a stable and sizable scale of operation, continue to exhibit a prudent manner in reducing and containing its financial leverage, and maintain its positive operating cash flow and liquidity position.

Key Rating Rationales

Leading and the Largest Private Steel Producer in China with Sizeable and Stable Operation: Shagang is one of the largest steel producers in the world and China's largest private steel producer, with a total production capacity of crude steel of c. 42 million tonnes at end-2020. The company was ranked 87th in the China Top 500 Enterprises and 351st in the Fortune 500 list in 2020, following China Baowu Steel Group which was ranked 111st and Hesteel Group which was ranked 218th, making it the top three steel producers from China on the Fortune 500 list in 2020. Shagang primarily focuses its sales in the Eastern China region such as Jiangsu, Zhejiang, Shanghai, which is a key steel consumption area and presents good fundamentals in terms of steel demand.

Under various guidelines and announcements made by the Chinese authorities such as the National Development and Reform Commission ("NDRC") in 2019, we believe that industry consolidation will continue to be the key theme in the next 3-5 years. In order to expand capacity, construction of new facilities is unlikely and mergers and acquisitions will be the primary means to do so.

High Capacity Utilization Rates and Operating Efficiency: Shagang has been maintaining an over 95% utilization rate in its pig iron and crude steel production in the past few years, above industry average, thanks to its continuous investments in the research and technological advancement to aid production streamlining and standardization. Shagang is also able to achieve an increase in per capita crude steel production in the past few years.

In terms of environmental protection and low emission standards, the Chinese authorities such as the Ministry of Ecology and Environment have set goals of upgrading steel production facility to reduce energy consumption, and emissions. Shagang has invested c. RMB6 billion in facilities upgrade for environmental protection, and we expect the company to continue to invest in this area, with annual CAPEX of c. RMB3 billion in the next 12-24 months.

Key Products Faced with Price Fluctuations: Rebars, hot-rolled and wire products accounted for c. 67% of Shagang's production and sales volume in 2020. High value-added products such as cold-rolled products, which command a higher average selling price (ASP), accounted for only c. 7% of its total production and sales volume.

Under the backdrop of the global economic slowdown and the impact of COVID-19, real estate construction activities in China significantly slowed down in Q1 2020. Gradual recovery in steel demand has been seen since 2H 2020. We expect steel demand to continue recovering and increasing in the next 12 months, driven by global stimulus incentives to boost economic growth.

In 2020, the average selling prices (ASP) for Shagang's products experienced a drop in tandem with the industry trend. There were price surges in various steel products in Q1 2021, and we expect prices to stabilize in 2H 2021 and the ASP for Shagang's key products to remain at higher level vis-à-vis 2020's in the next 12-18 months.

Upstream Expansions Provide Partial Supply Stability Amid Rising Raw Materials Cost; Slight Margins Improvement: Shagang has a low self-sufficiency rate in iron ore, with over 90% of needs being sourced externally, a majority from overseas. Decrease in the global supply of iron ore resulted from production disruption and stagnant output growth from key iron ore producers led to an increase in the price of iron ore. We expect the price of iron ore to remain at a relatively high level in the next 12 months.

Shagang has expanded upstream (even though total amount is small) and built long-term relationships with key and reputable raw material suppliers. The Jimblebar and Savage River mines in Australia supply a total of c. 3.4 million tonnes of iron ore to Shagang per annum. Shagang has also established strategic partnerships with reputable coke and coal suppliers such as Shenhua Group, Yankuang Group and Shanxi Coking Coal Group.

With raw materials cost at a relatively high level, despite the better prospect of growth in ASP of steel products, we expect the average per tonne gross margin of Shagang's steel products to improve to c. 15-18% level in the next 12-18 months, as compared with over 20% level in 2017 and 2018.

Access to Array of Financing Channels; Investments in Financial Products Dilute Cash Position Yet Provides Financial Flexibility: Shagang has strong access to an array of financial channels on the onshore capital market. It has established close business relationships with key banks which enable the company to obtain relatively low-cost financing for its operations. At end-2020, Shagang had c. RMB10.7 billion of cash on hand and unutilized credit lines of c. RMB178 billion to cover its short-term debt of c. RMB31.7 billion. Shagang has been able to generate good operating cash flow and we expect the company to continue to generate c. RMB10-12 billion of operating cash flow per annum in the next 12-24 months. Shagang has a relatively low working capital requirement, particularly in terms of receivables and payables, as sales and procurement are conducted on a payment in advance basis.

At end-2020, Shagang also had c. RMB20 billion of financial products, primarily consisting of short-dated non-high-risk products with tenors ranging from 3-9 months. The average return on these financial products was between 3-5%, which provides another source of financial flexibility though diluting the fully liquid cash position.

Acquisition of Stakes in Internet Data Centre Owner and Operator Adds to Leverage; Business Potentials to be seen: Following the acquisition of a further 24.01% stake in internet data centre owner and operator Global Switch Holdings Ltd. (Global Switch) in 2019, Shagang currently owns c. 51.7% of Global Switch on a see-through basis and consolidates it into its financials. Global Switch has a strong market position in the internet data centre segment. As Global Switch is being run operationally and financially as a standalone entity with minimal involvements and connection with Shagang, and Shagang primarily only exhibits ties via its

majority shareholder role, we consider the linkage between Shagang and Global Switch, from a credit perspective, to be weak and assess Shagang's profile on a deconsolidated basis.

Funding for the acquisition of Global Switch added to the financial leverage of Shagang. EBITDA Interest coverage decreased to c. 6-7x in 2019 and 2020 vs c.10-13x in 2017 and 2018. As Shagang gradually controls its financial leverage level, we expect Shagang to maintain an EBITDA/Interest coverage of c. 6x and a debt/EBITDA ratio at c. a 4-5x level in the next 12-18 months.

Shagang targets to leverage its own resources and network in China and Global Switch's strong expertise. That said, short-term synergies will be mostly on the transfer of technological know-hows in assisting Shagang to improve its own data analytical framework, in our view. We also continue to observe developments on any potential restructuring of Global Switch in the near to medium term.

Rating Sensitivities

We would consider downgrading Shagang's rating if it were to (1) aggressively expand into non-core businesses which results in an increase in its financial leverage[1] as measured by total debt/EBITDA to over 5.0x or a decrease in its EBITDA interest coverage to below 6.0x consistently, and/or (2) its operating performance were to deteriorate such that its revenue, margins or operating cash flow experiences a material decline or liquidity profile is worsened.

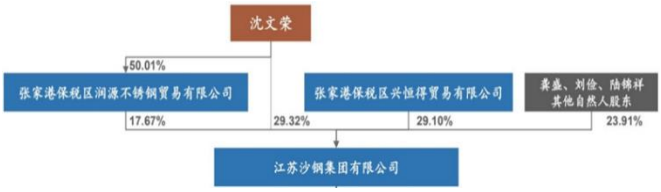
We would consider upgrading Shagang's rating if it were to (1) considerably increase its operating scale while maintaining competitive position in its core markets, and (2) reduce and maintain its financial leverage[1] as measured by total debt/EBITDA at below 3.0x or EBITDA interest coverage at above 8.0x consistently.

Company Profile

Shagang is a Chinese steel producer that focuses on producing a series of steel products which are widely used in construction, shipbuilding, automobiles and other fields. It was established in 1975 and became the largest private steel enterprise in China after years of developments. Shagang's two subsidiaries, Jiangsu Shagang Co., Ltd. and Grange Resources Limited, are listed on the Shenzhen Stock Exchange (002075.SZ) and Australia Stock Exchange (GRR.ASX) respectively.

Mr. Shen Wenrong（沈文荣） was Shagang's largest shareholder and he owned 38.16% of the company directly (29.32%) and indirectly (8.84%) through 张家港保税区润源不锈钢贸易有限公司 at end-2020. As the second-largest shareholder, 张家港保税区兴恒得贸易有限公司 owned 29.10% of the company.

Shagang's shareholding chart at end-2020



Note: Mr. Shen Wenrong（沈文荣）is the Chairman of Shagang
Source: Shagang

1. On a deconsolidated basis

Business Profile

Shagang's main business operation comprised steel and related products segment and non-steel segment. Sales of steel and related products are Shagang's major source of revenue. Their contribution to the total revenue increased to 77.3% in 2018 from 52.1% in 2016, and has maintained its position as the major source with gradual increase in total amount since then. In 2020, revenue derived from sales of steel increased to RMB102.1 billion from RMB100.9 billion in 2019 with a year-on-year increase of c. 1.2%. We expect the sales of steel and related products to continue experience nominal growth in the next 12 months.

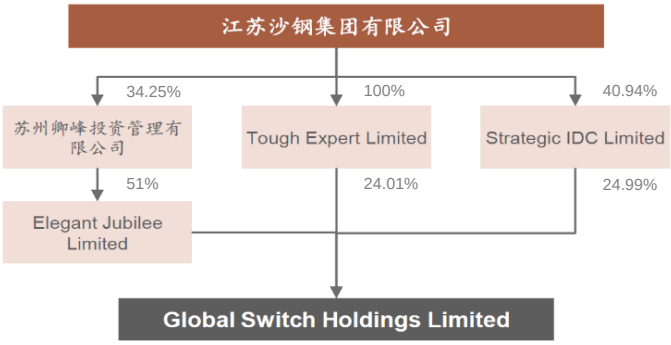
Non-steel segment mainly consists of trading and other business, as well as the internet data centre (IDC) business. Trading business is related to sales of iron ore, coal mine and coke, which is Shagang's another significant revenue source. Revenue from the trading business was RMB43.0 billion with a year-on-year growth of 13.8% in 2020 and it accounted for c. 28.8% of the total revenue in 2020. We expect its contribution to total revenue to maintain at a similar level in the next 12 months. Revenue from Others segment only accounted for less than 3% of the total revenue and their contribution to Shagang was limited when compared with Shagang's steel and trade businesses.

In August 2019, Shagang announced an acquisition of a further 24.01% of Global Switch Holdings Ltd. ("Global Switch"), a leading IDC owner and operator. At end-2020, Shagang owned c. 51.7% of Global Switch on a see-through basis and consolidated it into the company's financials. The acquisition of Global Switch is expected to boost Shagang's competitiveness in the big data and IDC area. However, given the vastly different business model of IDC and steel industry, the integration of Global Switch will post uncertainty in terms of operation and execution. We understand from the management that Global Switch's senior management will be retained and that Global Switch will be run as an independent company which we believe will be beneficial given the expertise required in running IDC is unique.

Revenue (RMB in millions) / % of total	FY2018		FY2019		FY2020	
Steel	**105,515**	**77.3%**	**100,890**	**71.9%**	**102,148**	**68.4%**
Trading	29,262	21.4%	37,836	27.0%	43,055	28.8%
Others	1,765	1.3%	410	0.3%	459	0.3%
IDC	-	-%	1,269	0.8%	3,693	2.5%
Total	**136,542**	**100%**	**140,405**	**100%**	**149,355**	**100%**

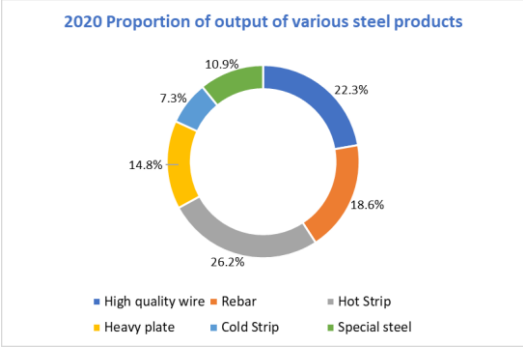
Source: Shagang

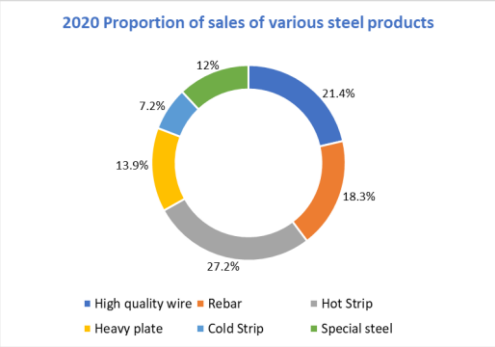
Ownership Structure of Shagang's Shareholding in Global Switch



Source: Shagang

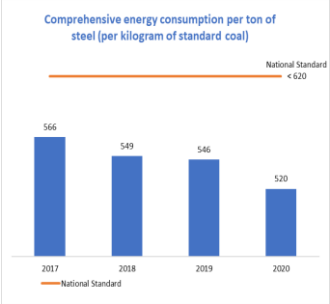
Sales and production volume breakdown by products in 2020

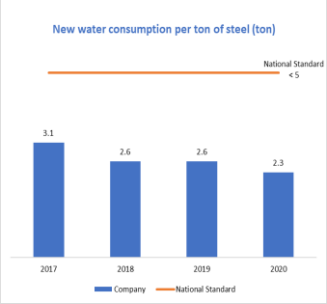




Source: Shagang

Upgrades for environmental protection positioned Shagang well for strict industry standards





Source: Shagang

Market Position

Shagang is the largest privately-owned steel producer in China as measured by output of crude steel. In terms of output of crude steel, Shagang maintained 3rd and 6th among the domestic and global steel producers respectively from 2017-2020, according to World Steel Association. Shagang was also ranked 87th in the China Top 500 Enterprises and 351st in the Fortune 500 list in 2020. China Baowu Steel Group was ranked 111st and Hesteel Group was ranked 218th, making Shagang the top three steel producers from China on the Fortune 500 list in 2020.

Financial Profile

Key Assumptions

- No increase in production capacity with utilization rates above 95% for 2021-2022
- c. 2% increase in revenue from sales of steel and related products for 2021-2022
- EBITDA margin of c. 11-12% for 2021-2022
- Annual capex of RMB3.5-5 billion for 2021-2022

Key Financial Metrics

2018A-2022F	Debt/EBITDA	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Average	4.1x	6.7x	36.1%	0.5x

Source: Shagang's 2018-2020 annual reports, Lianhe Global's adjustments and forecasts

Liquidity

Shagang's liquidity is adequate. At end-2020, the company had RMB10.7 billion of cash on hand and an unutilized credit line of c. RMB178 billion to cover its short-term debt of RMB31.7 billion. Shagang has been able to generate good operating cash flow and we expect the company to continue to generate c. RMB10-12 billion of operating cash flow per annum in the next 12-24 months.

In addition, Shagang's payment in advance sales and procurement policy, and decelerating investment pace also underpin its adequate operating cash flow. The company also has access to various financing channels and maintained good relationship with financial institutions onshore. We expect Shagang to continue to diversify its financing channels such as offshore USD bonds.

At end-2020, Shagang had c. RMB20 billion of financial products, primarily consisting of short-dated non-high-risk products with tenors ranging from 3-9 months. The average return on these financial products was between 3-5%, which provides another source of financial flexibility though diluting the fully liquid cash position.

Appendix I: Shagang's Rating Factors

Rating Factors	Weight	Initial Rating
I. Market Demand Analysis	**15.0%**	**bbb+**
II. Business Analysis[2]	**45.0%**	**bbb+**
III. Financial Analysis[3]	**40.0%**	**bbb**
IV. Base Score	**100.0%**	**bbb+**
V. Industry Risk		**bbb**
Base Rating		**bbb+**
VI. Qualifiers		
Liquidity		Neutral
Corporate Governance		Neutral
Debt Structure and Financial Policy		Neutral
Idiosyncratic Analysis		Neutral
Stand-Alone Creditworthiness (SAC)		BBB+
VII. External Support		
Corporate Entity Support		Not Applicable
Issuer Credit Rating		BBB+/Stable

Source: Lianhe Global

[2] Business Analysis contains sub-factors of market position, diversification, competitive position, operating efficiency and profitability.

[3] Financial Analysis contains sub-factors of debt/EBITDA, EBITDA interest coverage, debt/capitalization and quick ratio.

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