

# China Hongqiao Group Limited

## Surveillance Report

### Summary

|               |                                 |
|---------------|---------------------------------|
| Issuer Rating | BB+                             |
| Outlook       | Positive                        |
| Location      | China                           |
| Industry      | Metals and Mining<br>(Aluminum) |
| Date          | 28 April 2022                   |

### Operating Data:

| China Hongqiao Group Limited                                    | 2020   | 2021    |
|---|--------|---------|
| Revenue (RMB: in million)                                       | 86,145 | 114,491 |
| Reported Gross Margin (%)                                       | 22.5   | 26.6    |
| Annual Production Capacity of aluminum alloy (Tons: in million) | 6.5    | 6.5     |
| Production Volume of aluminum alloy (Tons: in million)          | 5.6    | 5.6     |

Source: China Hongqiao

**Lianhe Ratings Global Limited (“Lianhe Global”) has affirmed ‘BB+’ global scale Long-term Issuer and Issuance Credit Ratings of China Hongqiao Group Limited; Issuer Rating Outlook Revised to Positive**

### Summary

The Issuer Rating reflects China Hongqiao Group Limited’s (1378.HK) (“China Hongqiao” or “the company”) established leading market position, cost advantage backed by its vertically integrated production platform and economies of scale, as well as the solid financial performance supported by the prevailing high aluminum prices. However, China Hongqiao’s rating is constrained by the cyclical nature of the aluminum industry, policy and concentration risks.

The Positive Outlook reflects our expectation that China Hongqiao will maintain its operating performance and further improve its financial leverage, given its strong cash generation capability. We also expect China Hongqiao to be able to manage the execution risks related to its capacity migration to Yunnan Province. The production volume of transferred capacity should ramp up smoothly without compromising China Hongqiao’s operating efficiency.

### Rating Rationale

**Leading Market Position with Strong Cost Advantage:** China Hongqiao has maintained its market position as the world’s leading aluminum producer. The company has one of the world’s largest aluminum and alumina production capacities (6.46 million tons of aluminum and 16 million tons of alumina). Given its economies of scale and vertically integrated production platform with a stable low-cost supply of bauxite, China Hongqiao has a substantial cost advantage. Its reported gross margin was higher than its similarly sized peers in China. Considering that there is little product differentiation for aluminum, we believe being the lowest-cost producer is critical in the aluminum industry.

**Continuous Improvement in Financial Leverage:** China Hongqiao had consistently demonstrated a deleveraging trend in the past four years. Its financial leverage, as measured by debt over EBITDA, decreased to c. 2x at end-2021 from over 4x at end-2018. The deleveraging was primarily a result of its strong cash flow generation capability. However, China Hongqiao is undertaking a large-scale production capacity migration from Shandong Province to Yunnan Province, which requires c. RMB5.5-7.5 billion of capital expenditure in the next three years. We expect its financial leverage to remain below 3.0x in the next 12-24 months as the company has sufficient internal resources to address its capital needs.

**Strong Profitability Supported by the High Aluminum Prices:** China Hongqiao reported a record high revenue of RMB114.49 billion in 2021, representing a 32.9% year-on-year growth. The high growth of revenue was mainly driven by the rapidly rising aluminum prices in China due to the strong recovery of aluminum demand after the pandemic, the surging production costs (energy and raw materials), the reduction of output caused by the electricity shortage, as well as the limited production capacity. As a result, the company’s average sales price of aluminum alloy products increased by 33.5% to c. RMB16,500 per ton (excluding value-added tax). At the same time, China Hongqiao managed to keep its

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### Applicable Criteria

General Corporate Rating Criteria (31 December 2021)



production costs under control and logged a gross margin of 26.6% in 2021, up from 22.5% in 2020.

We expect China Hongqiao to maintain its gross margin at 22%-25% in the next 12-18 months. Although the Chinese property market has been in a downturn since 2H2021 which lowers the demand for aluminum in residential properties' construction sites, the shortfall could be partially compensated by the order from new energy industries such as electric vehicles and wind power generators. The Chinese government might also launch mass infrastructure investments as a countercyclical stimulation policy. In addition, the Russia-Ukraine conflict has led to a supply shock in the global aluminum market, boosting Chinese aluminum products' export. At the same time, the aggregate production capacity of aluminum is largely capped after the supply-side reforms in China, which gives aluminum producers a stronger bargaining power.

We also believe China Hongqiao has some extent of resistance to adverse industry dynamics due to its market position, cost advantage and the control of upstream raw materials. However, any significant interruption to its production volume or a severe demand crunch could still negatively impact China Hongqiao's operating performance.

**Capacity Replacement Could Mitigate Policy and Concentration Risks but Subjects to Execution Risks:** As an energy-intensive company, China Hongqiao faces heightened policy risk in the context of "dual carbon" and "dual control" policies. Also, the company has certain level of geographical and client concentration risks as most of its production facilities were located in Shandong Province and one single customer contributed to c. 40% of its total sales in the past three years.

In response, the company has launched its production capacity replacement project since 2019, migrating its aluminum production capacity of 3.96 million tons (about two-thirds of its total annual production capacity) to Yunnan Province from its Shandong Province's headquarter. China Hongqiao plans to complete the migration between 2027 and 2028, and it could possibly have the world's largest clean energy-powered aluminum production capacity by then. Although the NDRC of Yunnan Province decided to cancel all discounted electricity prices provided to aluminum manufacturers after 2021, we expect Yunnan Province's hydroelectric still has a cost advantage compared with conventional thermal power, considering the rising coal prices. We also believe the new plants in Yunnan can bring China Hongqiao a more diversified customer portfolio.

However, China Hongqiao faces uncertainty in electricity supply as the hydroelectric output has relatively strong seasonality and is easily impacted by drought. Less than one-fifth of China Hongqiao's one million tons of migrated capacity was under production in 2021 due to inconsistent electricity supply. In addition, China Hongqiao might incur higher transportation costs in Yunnan Province, a less-developed inland province with limited demand for aluminum products.

We expect China Hongqiao to manage such risks properly. The company plans to diversify its electricity sources in Yunnan Province by introducing other renewable energy sources such as wind power and solar power. The company is also attracting its downstream clients to build facilities around its plants in Yunnan.

## Rating Sensitivities

We would consider downgrading China Hongqiao's rating if (1) it were to increase its financial leverage as measured by its EBITDA interest coverage consistently below 4.0x or debt over EBITDA leverage consistently above 4.0x, or (2) 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 (1) it maintains its operating performance, (2) it migrates its production capacity to Yunnan province smoothly without compromising its operation efficiency, reducing its production and sales volume, and (3) it continues 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 'BBB' rating category.

## Company Profile

China Hongqiao is a leading large-scale aluminum producer that mainly focuses on producing and selling aluminum and aluminum products in China. It was established in 1994 by Mr. Zhang Shiping (father of the current Chairman Mr. Zhangbo) and has been listed on the Hong Kong Stock Exchange (1378.HK) since 2011.

Zhang's family was the largest shareholder and held c. 66.6% stake of China Hongqiao through Trust Company at end-2021. CITIC Group Corporation continued to be the strategic cooperator of China Hongqiao and was the second-largest shareholder, holding c. 9.6% shares of China Hongqiao.

### China Hongqiao's Shareholder Structure at end-2021

| Shareholder                            | Percentage    |
|--|---------------|
| Hongqiao Holdings <sup>(1)</sup>       | 66.6%         |
| Mr. Zhang Bo                           | 0.1%          |
| CITIC Group Corporation <sup>(2)</sup> | 12.7%         |
| Other Public Shareholders              | 20.6%         |
| <b>Total</b>                           | <b>100.0%</b> |

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

(2) Mainly held by CTI Capital Management Limited (8.8%), a subsidiary of CITIC Group Corporation. The rest was held by other CITIC Group Corporation's other subsidiaries.

Source: China Hongqiao

## Key Financial Assumptions

- Aluminum production volume: 5.8-6.3 million tons for 2022-2024
- Capital expenditure: RMB5.5-6.5 billion per annum for 2022-2024

### Key Financial Metrics

| 2020A-2024F      | Debt/EBITDA | EBITDA/Interest | Debt/Capitalization | Quick Ratio |
|------------------|-------------|-----------------|---------------------|-------------|
| Weighted Average | 2.2x        | 6.7x            | 36.8%               | 1.2x        |

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 affirmed at 'BB+'
- USD200 million 7.375% senior unsecured notes due 2023 affirmed at 'BB+'
- USD500 million 6.25% senior unsecured notes due 2024 affirmed at 'BB+'

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