

China Hongqiao Group Limited

Surveillance Report

Summary

Issuer Rating	BB+
Outlook	Positive
Location	China
Industry	Metals and Mining (Aluminum)
Date	4 May 2023

Operating Data:

China Hongqiao Group Limited	2021	2022
Revenue (RMB: in million)	114,491	131,699
Reported Gross Margin (%)	26.6	13.8
Annual Production Capacity of aluminum alloy (Tons: in million)	6.5	6.5
Production Volume of aluminum alloy (Tons: in million)	5.6	6.0

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 remains 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 economy 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 and its regulation and concentration risks.

The Positive Outlook reflects our expectation that China Hongqiao will maintain its operating performance and improve its operating efficiency, given its strong cash generation capability and its advanced cost advantage. Moreover, the production volume of migrated capacity in Yunnan Province is expected to ramp up smoothly without compromising China Hongqiao’s operating efficiency.

Rating Rationale

Reviving Domestic Economy Supporting Aluminum Demand: China Hongqiao reported revenue of RMB131.7 billion in 2022, representing a 15.0% year-on-year growth. The revenue growth was mainly driven by the increase in both aluminum prices and sales volume. The company’s average sales price of aluminum alloy products increased by 5.4% to c. RMB17,500 per ton (excluding value-added tax). Meanwhile, the company’s sales volume of aluminum alloy products increased by 8.3% to 5.47 million tons, as compared with the sales volume of 5.05 million tons in 2021.

Despite coming down from historical high prices, aluminum price in China has been underpinned by the rising production costs (energy and raw materials), the reduction of output caused by the electricity shortage, as well as the limited production capacity. In addition, the domestic demand for aluminum is expected to rise as the economy gradually revives from the trough, especially given the expected recovery of the construction sector, along with the further development of the new energy vehicles sector and electric grid infrastructure sector. Global sector sentiment is expected to recover in 2023 under the backdrop of slowing down of Fed rate hike cycle during the year.

Given China Hongqiao’s leading market position and vertically integrated production chain, we believe that the company is likely able to seize the chance and maintain sustainable growth in revenue in the future.

Leading Market Position with 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 19.5 million tons of alumina). Given its economies of scale and vertically integrated production platform with a stable low-cost supply of bauxite from the West African country Guinea afford the company a substantial cost advantage. Therefore, the company continued to maintain a good reported gross margin vs. its similarly sized peers in China. Considering

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Applicable Criteria

General Corporate Rating Criteria (31 December 2021)

that there is little product differentiation for aluminum, we believe being the lowest-cost producer is critical in the aluminum industry.

China Hongqiao's reported gross margins were 22.5%, 26.6% and 13.8% in 2020, 2021 and 2022, respectively. The sharp decrease in gross margin in 2022 was mainly due to the surge in the cost of raw materials and freight costs resulted from the complex market situation and soaring energy prices. Historically, China Hongqiao has demonstrated the ability to improve its margin through adverse industry dynamics. Besides, the migration of total 2 million tons capacity has been gradually deployed in Wenshan Autonomous Prefecture, Yunnan Province, which is expected to further lower the company's production cost to some extent, despite the impact from the strong seasonality of the hydroelectric output and possible drought. Overall, given the expected support in aluminum prices and the company's cost advantage, we expect that China Hongqiao's gross margin is likely going to recover to above 15% in the next 12-24 months.

Vertically Integrated Production Platform and High Self-sufficiency Rates: China Hongqiao has established a vertically integrated production platform comprising a 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. Particularly, the bauxite annual output has been stable at over 40 million tons in the past several years in Guinea despite the changes in the local authority. The access to bauxite in Australia further diversifies the company's raw material source. The 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. Also, China Hongqiao has been investing in upgrading its facilities to meet stricter environmental standards, which could further strengthen the company's competitive positioning in the aluminum industry in China.

Tightened Liquidity with Continuous Optimization of Capital Structure : China Hongqiao had consistently demonstrated efforts of optimizing its capital structure in the past five years. With total debt decreased from RMB82.9 billion at end-2018 to RMB60.1 billion at end-2022, its debt capitalization ratio continued to decrease in 2022, to 38.3% at end-2022 from 39.7% at end-2021, as compared with 57.3% at end-2018. However, China Hongqiao's liquidity was tightened in 2022, with unrestricted cash on hand dropping to RMB27.4 billion at end-2022 from RMB49.2 billion at end-2021. This was mainly due to the company using internal funds to repay maturing debts and the company's latest strategy to increase inventories as a response to the post-COVID recovery in China. In comparison, China Hongqiao's reported short-term debts increased to RMB43.4 billion at end-2022 from RMB30.1 billion at end-2021. As a result, China Hongqiao's unrestricted cash/short-term debt declined to 63.0% at end-2022 from 163.6% at end-2021. Nevertheless, China Hongqiao had undrawn bank facilities of RMB27.0 billion at end-2022 and the company has maintained good access to the capital market including equity placement, offshore and onshore bond issuance, convertible bond issuance, etc. Therefore, we believe China Hongqiao's liquidity is still adequate to provide ample buffer to the market volatility.

China Hongqiao's financial leverage, as measured by debt over EBITDA, bounced to c. 3x at end-2022 from c. 2x at end-2021, which was mainly due to the decline in EBITDA resulting from the decrease in the company's gross margin in 2022. Given our expectation of the

recovery of the company's gross margin, we expect its financial leverage to improve to below 3.0x in the next 12-24 months.

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 materially worsened.

We would consider upgrading China Hongqiao's rating if (1) it maintains its operating performance, and (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.

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. 64.2% stake of China Hongqiao through Trust Company at end-2022. CITIC Group Corporation continued to be the strategic cooperator of China Hongqiao and was the second-largest shareholder, holding c. 12.7% shares of China Hongqiao.

China Hongqiao's Shareholder Structure at end-2022

Shareholder	Percentage
Hongqiao Holdings ⁽¹⁾	64.1%
Mr. Zhang Bo	0.1%
CITIC Group Corporation ⁽²⁾	12.7%
Other Public Shareholders	23.1%
Total	100.0%

(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 (8.5%), 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: 5.7-6.1 million tons for 2023-2025
- Capital expenditure: RMB5.5-8.5 billion per annum for 2023-2025

Key Financial Metrics

2021A-2025F	Debt/EBITDA	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Average	2.3x	6.5x	35.1%	0.7x

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:

- 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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