China Hongqiao Group Limited

Initial Issuer Report

Summary	
Issuer Rating	BB
Outlook	Positive
Location	China
Industry	Metals and Mining
Date	20 September 2019

Operating Data:
China Hongqiao Group Limited

	31 Dec 2017	31 Dec 2018
Revenue (RMB: in million)	97,942	90,195
Annual Production Capacity (Tons: in million)	6.46	6.46
Weighted Average Production Capacity [(1)] (Tons: in million)	7.95	6.46
Production Volume (Tons: in million)	7.54	6.37
Utilization Rate [(2)] (%)	94.9	98.5

(1) Total sum of the production capacity of each of the company's production lines multiplied by the months in that period (annualized) that such production line possessed such capacity divided by the number of months in that period
(2) Production volume divided by the weighted average production capacity

Source: China Hongqiao

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Applicable Criteria
General Corporate Rating Criteria (16 July 2018)

Lianhe Ratings Global Limited ("Lianhe Global") has assigned a 'BB' global scale Long-term Issuer Credit Rating to China Hongqiao Group Limited. The Outlook is Positive.

Summary

The Issuer Rating reflects China Hongqiao Group Limited ("China Hongqiao" or the "company")'s leading market position, economy of scale, high operating efficiency and investments in both technologies and overseas alumina production to stay ahead of the curve. However, the rating is constrained by the company's moderately high financial leverage, lack of pricing power, embedded currency and policy risks.

The Positive Outlook reflects our expectation that China Hongqiao has competitive advantages in terms of investing in the (1) overseas alumina production which is likely to boost its revenue in 2022 or earlier and (2) emission reduction technologies ahead of the implementation of the stricter emission standards in 2021.

Rating Rationale

Leading Market Position: China Hongqiao is one of the largest aluminum smelters in the world with an annual production capacity of 6.46 million tons. It has 8 aluminum production plants along with captive power plants in Shandong China and one alumina plant in Indonesia. 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 customers.

Vertically Integrated Production Platform: 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.

Highly Self-sufficient: China Hongqiao is able to source over 80% of its raw material (i.e. bauxite) and electricity consumption via its vertically integrated production platform. This platform insulates China Hongqiao from market price gyration of the two major cost components of aluminum production: raw material (i.e. bauxite) and electricity. This high degree of self-sufficiency enables China Hongqiao to keep costs under control to stay competitive.

High Operating Efficiency: China Hongqiao operates its plants on a 24-hour-a-day and 7-day-a-week schedule throughout the year. The company only shuts down parts of the modules for maintenance. Its utilization rate of 98.5% in 2018 was improved from 94.9% in 2017 and 96.5% in 2016, which we view favorably. We expect China Hongqiao to maintain a high operating efficiency in the next 2-3 years.

Sufficient Liquidity: China Hongqiao has sufficient liquidity as it had RMB42.1 billion cash on hand at end-1Q2019 to cover its remaining RMB21.7 billion debt due in 2019. The company had RMB10.5 billion restricted assets at end-2018, of which RMB1.3 billion was restricted cash and the remaining RMB9.3 billion were PP&E. The company had RMB176.7 billion total assets at end-2018.

China Hongqiao had a credit line totalling RMB58 billion, of which RMB44.6 billion had been used at end-1Q2019. It also has a USD500 million offshore bond issuance quota available, of which it has utilized USD300 million following the issue of 7.125% Senior Notes due 2022 in July 2019 (Lianhe Global: BB).

Rating Sensitivities

We would consider upgrading China Hongqiao's rating if it were to successfully execute its alumina projects in Guinea and Indonesia which results in revenue growth consistently and maintain its current financial leverage as measured by its EBITDA interest coverage and debt over EBITDA leverage commensurate with the 'BB' rating category.

We would consider downgrading China Hongqiao's rating if it were to increase its financial leverage as measured by its EBITDA interest coverage consistently below 3x or debt over EBITDA leverage consistently above 5.5x, or it suffers a significant deterioration in EBITDA margin below 20% consistently.

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. China Hongqiao has 8 aluminum production plants along with captive power plants in Shandong China and one alumina plant in Indonesia, which provide the company vertically integrated operations that produce alumina, molten aluminum alloy and aluminum alloy ingots, as well as aluminum fabrication products.

Mr. Zhang Shiping, founder and former chairman of the board, was the largest shareholder and held 70.04% stake of China Hongqiao through a trust company at end-2018. Mr. Zhang Bo, CEO of the company since January 2011 and son of Mr. Zhang Shiping, was elected as the chairman of the board in May 2019 following the decease of Mr. Zhang Shiping.

CITIC Group Corporation became a strategic partner (through investments, provision of credit line and financial services) of China Hongqiao in 2017 and it was the second largest shareholder, who, together with its direct and indirect subsidiaries, held approximately 10.11% of China Hongqiao at end-2018. (EXHIBIT 1).

Molten aluminum alloy and aluminum alloy ingots were the main contributors to the company's revenue in 2015 and 2016, representing more than 95%. The capacity cut imposed by the Chinese government on aluminum smelters, together with the company's venture into the alumina segment, led to the change in contribution mix to revenue, with more than 20% of revenue deriving from sale of alumina and aluminum fabrication products in 2018. (EXHIBIT 2).

Exhibit 1: China Hongqiao's Shareholder Structure at end-2018

Shareholder	Percentage
Hongqiao Holdings [(1)]	70.04%
CTI Capital Management Limited [(2)]	9.30%
CNCB (Hong Kong) Investment Limited [(2)]	0.81%
Other Public Shareholders	19.85%
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's 2018 annual report

Exhibit 2: China Hongqiao's Revenue Breakdown by Segment (RMB: in million)

Revenue / % of total	FY2015		FY2016		FY2017		FY2018	
Molten Aluminum alloy	40,292	91.3%	53,848	87.7%	76,001	77.6%	67,420	74.7%
Aluminum alloy ingots	1,731	3.9%	5,089	8.3%	11,720	12.0%	4,096	4.5%
Aluminum fabrication	2,031	4.6%	2,413	3.9%	5,417	5.5%	7,135	7.9%
Alumina	-	-	-	-	4,629	4.7%	11,045	12.2%
Stream supply income	56	0.1%	46	0.1%	175	0.2%	499	0.6%
Total	**44,110**	**100.0%**	**61,396**	**100.0%**	**97,942**	**100.00%**	**90,195**	**100.0%**

Source: China Hongqiao's 2016-2018 annual reports

Business Profile

Leading Market Position

China is one of the fastest growing major economies in the world, with rapid increase in investments in fixed assets and infrastructures in the past decade. After a phase of rapid increase, growth rates of GDP and fixed asset investments have slowed down in recent years on the backdrop of global economic slowdown and the Chinese government's effort to re-balance the economy through various fiscal policies. In order to be competitive in the aluminum industry, producers strive to be the lowest cost producers given they have little or no pricing power and product differentiation.

The Chinese governmental authorities have promulgated a series of policies on the aluminum industry since 2009, which aimed to strengthen and streamline the development of the aluminum industry in China. The Notice of Specific Action Working Plans Regarding Regulating Unlawful Electrolytic Aluminum Projects (《清理整顿电解铝行业违法违规项目专项行动工作方案的通知》) announced in April 2017 was the latest round of such initiative. As a result of these policies, China Hongqiao was required to reduce production scale by shutting down electricity aluminum projects with a production capacity of 2.68 million tons.

Despite the cut, the company remains one of the largest aluminum producers in the world and in China. It has 8 aluminum production plants along with captive power plants in Shandong China and one alumina plant in Indonesia. The company has signed long-term contracts with its upstream raw material suppliers and it has also established long-term business relationships with its downstream customers. It is unlikely that there will be further cuts in the company's production capacity from a policy perspective in the near term since there was no further major supply-side reform initiative announced since 2017. Therefore, we believe, given the wide range of industrial application of aluminum and the company's market position, China Hongqiao is likely able to maintain its current sales volume in the next 12-24 months.

Vertically Integrated Production Platform Providing Cost Competitiveness

China Hongqiao has established a vertically integrated production platform comprising a stable supply of bauxite, refinery plants (of bauxite), alumina plants with captive power plants, as well as aluminum fabrication plants. It strives to be self-sufficient in terms of supply of raw material, i.e. bauxite, and electricity to achieve cost competitiveness. It procures a majority of bauxite from bauxite mining projects in Guinea, with a lesser extent from Australia and the rest from places such as Indonesia, India, Brazil and Malaysia. Its self-produced alumina satisfied c. 87% of the company's demand and self-produced electricity satisfied c. 78% of the company's total electricity needs for 2018. (EXHIBIT 3)

All in, the company has achieved a high degree of self-sufficiency on the two main cost components of aluminum production and thus it is able to control its production cost and strives to be one of the lowest cost producers. The company has constantly kept its cost of production lower than its peers which we view favorably.

Exhibit 3: China Hongqiao's Self-sufficiency %

Self-sufficiency %	FY2017	FY2018
Alumina	85.7%	87.1%
Electricity	73.8%	78.3%

Source: China Hongqiao

Improving and High Operating Efficiency

China Hongqiao operates its plants on a 24-hour-a-day and 7-day-a-week schedule throughout the year. It only shuts down parts of the modules during regular maintenance periods. It achieved a utilization rate of 98.5% in 2018, improved from 94.9% in 2017 and 96.5% in 2016, which we view favorably.

Aluminum production is subject to various environmental laws and regulations. During the prior production cuts in 2017, the company took the opportunity to close down its less efficient plants and also upgraded its equipment to meet the stricter emission standards in China which will be enforced in 2021. According to the company, all of its current production plants and power plants meet the 2021 emission standards.

We expect the company to maintain a high operating efficiency in the next 2-3 years. We believe operating efficiency is one of the most important factors after market position when we assess a commodity-like producer.

Customer Concentration Despite Long-term Relationships

China Hongqiao sells its aluminum products to customers such as downstream aluminum fabrication product manufacturers and traders located primarily in Shandong Province. According to the company, most of its molten aluminum alloy customers are located in close proximity to its manufacturing base. While the company has established long-term relationships with some of its client base, the largest five customers represented more than 50% of the company's revenue in the past two years (i.e. c. 66% in 2017 and c. 59% in 2018). The largest customer represented c. 40% of the company's revenue in 2018. This concentration of customers may constrain the ability of the company to maintain a stable sales volume and pose risk to the demand of the company's products if the relationship with one or more of its top customers turns unfavorable.

Financial Profile

Capacity Restrictions Constrain Revenue Growth

We expect the company's revenue to remain relatively flat in the next 12-24 months, given (i) the supply-side reform and the reduction of the company's production capacity to 6.46 million tons, limiting volume growth, (ii) relatively stable realized price expectation for the company's aluminum products, and (iii) the projects in Guinea including the development of a bauxite-mining project and an alumina plant will take some time to contribute to the company's top line revenue growth.

Moderately High Financial Leverage

China Hongqiao's consolidated financial leverage, defined as adjusted gross debt to capitalization, was moderately high at c. 57.3% at end-2018, mainly due to the production expansions prior to 2017. The company has since decelerated its expansion due to production cuts. Meanwhile, the company had capital expenditure on improving its equipment in order to meet stricter emission standards. The company plans to add capacity to its overseas alumina production in Indonesia with limited capital expenditure. The capital expenditure on the projects in Guinea is expected to be spread across a five-year horizon. We expect the company to moderately increase its debt level to partially fund its capital expenditure in its overseas projects, hence we expect the company's financial leverage to remain stable at the current level while its debt over EBITDA may weaken as a result of relatively flat revenue growth and margins in the next 12-24 months.

Key Assumptions

- Revenue: Relatively stable at c. RMB91 billion for 2019-2021
- Gross and EBITDA margins: Stable at the current level for 2019-2021
- Capital expenditures: c. USD1,300 - 1,500 million (c. USD430 - 500 million per annum on average) to be funded via internal resources and borrowings

Key Financial Metrics

2017A-2021F	Debt/EBITDA	EBITDA/Interest	Debt/Capitalization	Quick Ratio
Weighted Avg	4.7x	3.7x	57.4%	1.26x

Source: China Hongqiao's 2017-2018 annual reports and Lianhe Global's adjustments and forecasts

Liquidity

China Hongqiao has sufficient liquidity as it had RMB42.1 billion cash on hand at end-1Q2019 to cover its remaining RMB21.7 billion debt due in 2019. The company had RMB10.5 billion restricted assets at end-2018, of which RMB1.3 billion was restricted cash and the remaining RMB9.3 billion were PP&E. The company had RMB176.7 billion total assets at end-2018.

China Hongqiao had a credit line totalling RMB58 billion, of which RMB44.6 billion had been used at end-1Q2019. It also has a USD500 million offshore bond issuance quota available, which it has utilized USD300 million of such following the issue of 7.125% Senior Notes due 2022 in July 2019 (Lianhe Global: BB). Pursuant to an agreement in June 2017, China CITIC Bank agreed to provide the company with a comprehensive credit line of up to RMB20 billion over a two-year period, and to provide the company with financial services such as cash management, supply chain finance, investment banking services, international trade services, asset management services and capital market services.

China Hongqiao's short-term and long-term debts are evenly distributed that its short-term debt at end-2018 accounted for c. 33% of its total debt.

Appendix I: China Hongqiao's Rating Factors

Rating Factors	Weight	Initial Rating
I. Market Demand Analysis	**15.0%**	**bbb-**
II. Business Analysis[1]	**45.0%**	**bb+**
III. Financial Analysis[2]	**40.0%**	**bb**
IV. Base Score	**100.0%**	**bb+**
V. Industry Risk		**bb**
VI. Qualifiers		
Liquidity		Neutral
Corporate Governance		Neutral
Debt Structure and Financial Policy		Neutral
Idiosyncratic Analysis		Neutral
Stand-Alone Creditworthiness (SAC)		**bb+**
VII. External Support		
Corporate Entity Support		Nil
Issuer Credit Rating		**BB / Positive**

Source: Lianhe Global

The "bb+" SAC vs. Issuer Credit Rating of "BB" Positive Outlook are mainly attributed to the following key factors:

Volatility nature of commodity-like products

There is limited product differentiation and price bargaining power for China Hongqiao's current aluminum product offerings. The aluminum industry has commodity-like natures and aluminum product manufacturers are striving to differentiate their products through technological advancement for usage such as in the airline industry. There is also a lack of price bargaining power for molten aluminum products. This commodity-like industry nature presents an inherent volatility risk to the company's aluminum products.

Embedded currency risk

Most of China Hongqiao's sales are in RMB from China, while its raw material procurements in Guinea, Australia and other overseas countries are in foreign currencies. Per our discussions with the company, they only have a negligible amount of currency hedging. Although the company has good relationships and long-term contracts with their suppliers, there still presents an embedded currency risk in terms of revenue and expenses matching.

Uncertainty in both policy risks and the outcome of the Sino-U.S. trade tensions

The Chinese government has promulgated a number of policies to strengthen and streamline the aluminum industry in China, particularly through measures on capacity, efficiency and environmental-related matters. China Hongqiao cut its capacity to 6.46 million tons in 2017 in response to such policies. With the ongoing Sino-U.S. trade tensions and a slowing economy, there remains a lack of certainty in what impact the Chinese government's shifting/changing policies may have on the aluminum industry in China.

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

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

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