

## Credit Opinion

25 July 2023

Ratings	
Category	Corporate
Domicile	China
Rating Type	Solicited Rating
Long-Term Credit Rating	A <sub>9</sub> -
Outlook	Stable

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## Shandong Luqiao Group Co., Ltd.

### Initial credit rating report

**CCXAP assigns first-time long-term credit rating of A<sub>9</sub>- to Shandong Luqiao Group Co., Ltd., with stable outlook.**

### Summary

The A<sub>9</sub>- long-term credit rating of Shandong Luqiao Group Co., Ltd. (“SDLQ” or the “Company”) reflects the Company’s (1) solid market position in Shandong Province, particular in the area of road and bridge construction; (2) good order backlogs and profit margin; and (3) good access to funding.

However, the rating is constrained by the Company’s (1) geographic concentration; (2) higher investment risks from increasing public-private partnership (“PPP”) projects; and (3) rising debt levels with rapid business growth.

The rating also reflects our expectation of a very high likelihood of support from SDLQ’s parent, namely Shandong Hi-speed Road & Bridge Group Co., Ltd. (“SHRB”), given SDLQ’s (1) status as the core subsidiary of SHRB in engineering and construction business; and (2) close business and financial linkages with SHRB. We believe that SHRB has a strong capacity to support the Company by dint of SHRB’s (1) status as a key subsidiary of Shandong Hi-Speed Group Co., Ltd. (“SDHS”) which is ultimately owned by the Shandong Provincial Government; (2) strong strategic role for SDHS in the development of construction business; and (3) good track record of strong shareholder and government support.

The stable outlook on SDLQ’s rating reflects our expectation that the Company’s important position to its parent company is unlikely to change. We also expect the Company to maintain stable credit metrics and sufficient liquidity over the next 12 to 18 months.

## Rating Drivers

- Very high likelihood of support from its parent company when necessary
- Strong market position in road and bridge construction market in Shandong Province
- Good project backlogs but having a geographic concentration
- Higher investment risk from increasing PPP projects
- Rising debt levels with rapid business growth
- Good access to funding

## Rating Sensitivities

### What could upgrade the rating?

The rating could be upgraded if (1) the credit quality of SHRB improves, given the close business and financial linkages between SHRB and SDLQ; or (2) SDLQ's standalone credit quality improves significantly, including stronger market position, diversified operating scale, and improved credit metrics.

### What could downgrade the rating?

The rating could be downgraded if (1) the credit quality of SHRB deteriorates or parental support is expected to be weakened; or (2) SDLQ's standalone credit quality worsens significantly, including a material drop in market share, deterioration in credit metrics, and poor liquidity management.

## Key Indicators

	2020FY	2021FY	2022FY
Total Assets (RMB billion)	40.5	56.0	71.7
Total Equity (RMB billion)	9.8	12.0	16.7
Total Revenue (RMB billion)	30.0	42.9	50.2
Net Profits (RMB billion)	1.3	2.2	2.7
EBITDA/Revenue (%)	7.2	9.0	8.8
Return on Net Assets (%)	13.0	15.5	16.2
Total Debt/Total Capital (%)	50.5	52.7	47.7
Total Debt/EBITDA (x)	4.4	3.1	3.2
EBITDA/Interest (x)	4.9	3.9	5.6

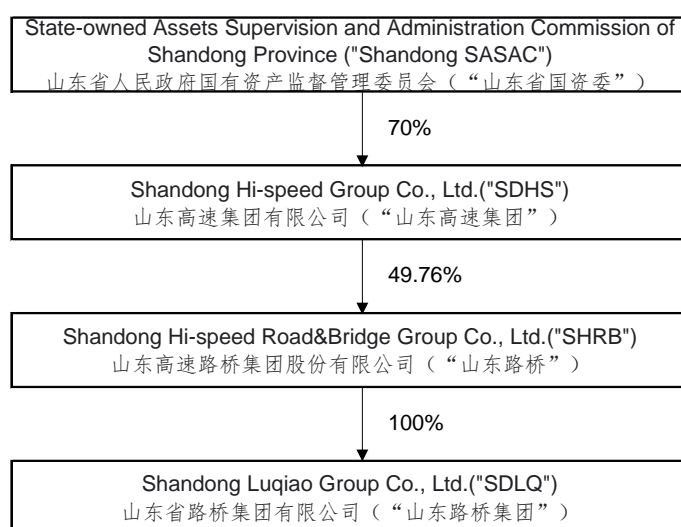
All ratios and figures are calculated using CCXAP's adjustments.

Source: Company data, CCXAP research

## Corporate Profile

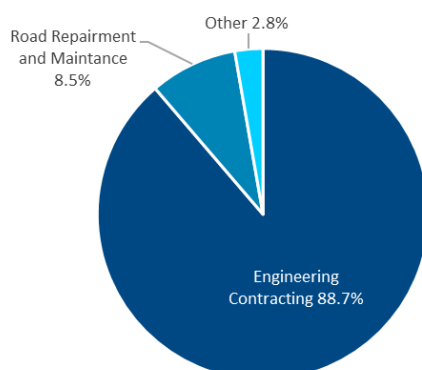
Established in 1948, SDLQ is one of the leading engineering and construction ("E&C") company in Shandong Province that experts in the construction of roads and bridges. As of the end of December 2022, the Company was wholly owned by SHRB, a Shenzhen listed construction company (000498.SZ) that was 49.76% owned by SDHS. SDHS was the largest SOEs by total assets in Shandong Province and was owned and controlled by the State-owned Assets Supervision and Administration Commission of Shandong Province ("Shandong SASAC"). SDLQ reported total revenue of RMB50.2 billion in 2022 and total assets of RMB71.7 billion as of 31 December 2022.

### Exhibit 1. Shareholding chart as of 31 December 2022



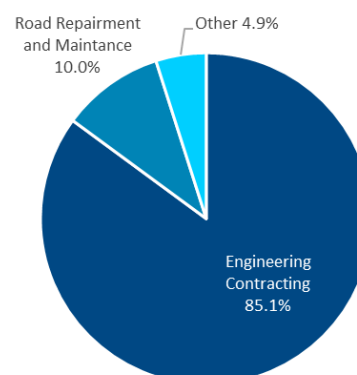
Source: Company information, CCXAP research

### Exhibit 2 Revenue structure in 2022FY



Source: Company information, CCXAP research

### Exhibit 3 Gross profit structure in 2022FY



## Rating Considerations

### Strong market position in road and bridge construction market in Shandong Province

SDLQ is a leading construction company in Shandong Province, particular in the area of road and bridge construction. The Company has more than 50% market share in highway construction in Shandong Province. It demonstrates a good track record in the construction of transportation infrastructure and has participated in multiple major road and bridge projects in Shandong Province, such as, Weishan Lake Bridge, Weifang-Rizhao Expressway and Zaozhuang-Heze Expressway. It has also gained market recognition and has earned meaningful engineering and construction prizes including China Construction Engineering Luban Prize and Tien-yow Jeme Civil Engineering Prize.

SDLQ possesses good technical know-how and sufficient industry qualifications, which enable it to be more competitive in tendering market and access to quality projects. It has 2 top-grade qualifications of general contracting for highway works and municipal utility works as well as 2 Class-A qualifications for engineering design of highway and municipal utility. It has accumulatively owned 1,003 authorized patents, including 149

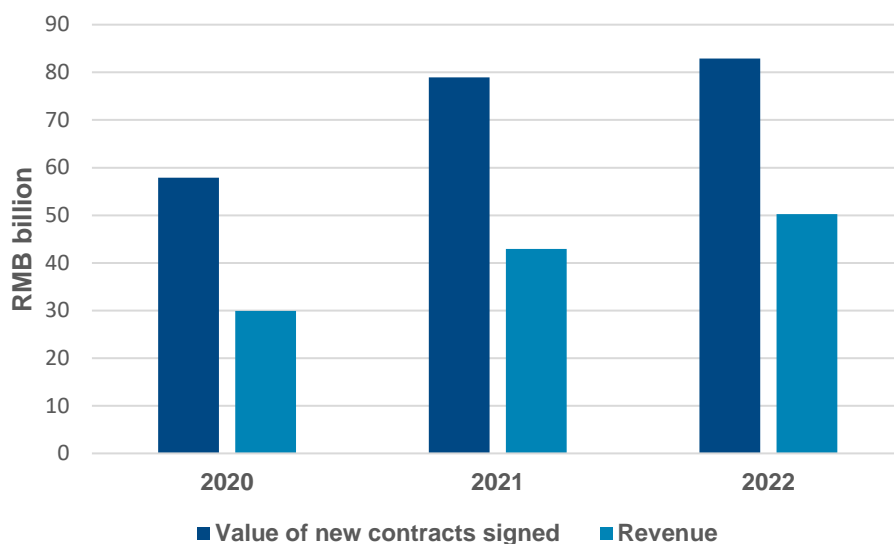
invention patents. The entry barriers for SDLQ's key business in road and bridge construction is higher than the general construction market because of the higher technical requirements.

In addition, SDLQ's market position is enhanced by the strong business support from SDHS. Before 2022, nearly 50% of the Company's newly signed contracts amount came from SDHS per year. SDHS is the largest road and bridge owner in Shandong Province with substantial needs for road and bridge construction. Leveraging by the Company's reputability, SDLQ gradually expands to other construction fields such as housing, railways, ports, and tunnels.

### Good project backlogs but having a geographic concentration

Underpinned by the order support from SDHS and its expansion in other construction fields and outside Shandong Province, SDLQ demonstrates good project reserves that help support its future business growth. SDLQ's total revenue increased from RMB30.0 billion in 2020 to RMB50.2 billion in 2022, of which above 88% came from engineering contracting over the past three years. The engineering contracting income had an increasing trend which is supported by good project backlogs. As of end-2022, the Company had project backlogs with a total contract amount of RMB82.8 billion. The Company also has a strong capacity to acquire new projects. Newly signed contracts grew from RMB57.9 billion in 2020 to RMB82.9 billion in 2022. In addition, more than 70% of new projects are over RMB500 million in contract size over the past three years, which could benefit cost control and help maintain a better project margin.

### Exhibit 4. SDLQ's revenue and value of new contracts signed from 2020 to 2022



Source: Company information, CCXAP research

However, SDLQ's rating is constrained by its geographically concentrated operation in Shandong Province. The business growth is highly associated with the local construction needs in the province and SDHS's investment planning. Affected by the postponement of SDHS's bidding, the growth pace in newly signed contracts of SDLQ slowed down in 2022. The Company also explores the overseas market along with the national "Belt and Road" layout. In 2022, the Company obtained the Kenya Highway EPC project and Tanzania Pangani Bridge project, while the overseas contract still contributes a small proportion of around 8.5% of newly signed contracts. Overseas projects would undertake higher operational, legal and execution risks.

SDLQ's project quality is considered high quality. Most of the Company's clients are SOEs that have lesser payment risk. Road construction and municipal utility accounted for 65% of newly signed contracts over the past three years. Such businesses are less influenced by the change in macro environment.

We expect SDLQ's project reserves to continuously grow supported by the high investment needs of the Shandong Provincial Government who plans to invest more than RMB310 billion in transportation in 2023, with a YoY growth rate of 15%, and targets to increase the mileage of highways to 10 thousand kilometers by 2025.

### **Higher investment risk from increasing PPP projects**

Besides the engineering contracting business, SDLQ makes some investments in public-private partnership (PPP) projects that are capital-intensive and require a longer return period. As of the end of 2022, the Company totally had 28 PPP projects in hand, all of which have been listed in the project management database of the Ministry of Finance. Participating in PPP projects is expected to make a good effect on the growth of construction business. As of end-2022, the PPP projects are expected to bring construction contracts of around RMB21.5 billion to the Company. However, the Company faces pressure on future capital expenditure with ongoing investment in these projects and will undertake higher investment risk. As of end-2022, there were 18 projects that the Company participates in as the controlling shareholder, with a total investment of around RMB12.5 billion and an uninvested amount of RMB7.9 billion. They were mainly road and bridge projects such as municipal roads and highways with operation periods of 8-10 years and mainly balanced under the mode of government repayment. The Company took part in the other 10 projects as the minority shareholder, which has a total investment of around RMB1.8 billion and an uninvested amount of RMB1.3 billion.

### **Heightened debt levels with rapid business growth**

SDLQ has a good EBITDA margin, which is mainly driven by its good cost control and margins in its engineering contracting business. Besides, the Company's road repairment and maintenance business is a good complement to its profitability, which provides a recurring revenue stream with a higher gross margin of over 10%. SDLQ has moderate leverage compared to its peers and has continued to reduce its leverage by increasing earnings while controlling its capital spending and debt growth. The Company's debt/EBITDA improved to 3.2x in 2022 from 4.4x in 2020. The total capital ratio (total debt/total capital) also decreased to 47.7% in 2022 from 52.7% as capital injection from its parents. However, the Company's debt grew fast with rapid business expansion. It had total debt (including perpetual capital) of RMB 14.2 billion at end-2022, with an average annual growth rate of around 22% over the past three years.

In addition, the Company's capacity to gain cash was weak. Its CFO is unable to cover interest expenses. In addition, the contract assets and account receivables totally accounted for a large portion of around 50% of total assets as of the end of 2022, which were mainly unsettled amounts of completed projects. The Company relies on external financing to meet the financial needs and debt repayment. As of the end of 2022, the short-term debt amounted to RMB8.4 billion, accounting for around 59% of total debt.

### **Good access to funding**

SDLQ has good access to funding including its parent company and banks with low costs. As of the end of 2022, the Company obtained total bank credit facilities of RMB60.6 billion, of which the available part was RMB35.9 billion, providing good financial flexibility. In addition, SDLQ has a track record of receiving capital and funding support from its parent company, SHRB, including providing money lending and guarantees when needed. For example, SHRB injected around RMB3.0 billion into the Company in 2022.

## External Support

SDLQ is very likely to receive support from SHRB when necessary, given its (1) status as the core subsidiary of SHRB in engineering and construction business; and (2) close business and financial linkages with SHRB. We believe that SHRB has a strong capacity to support the Company because of its (1) status as a key subsidiary of SDHS which is ultimately owned by the Shandong Provincial Government; (2) strong strategic role for SDHS in the development of construction business; and (3) good track record of strong shareholder and government support.

SDLQ has a very important position in SHRB's operations as the primary operating subsidiary in roads and bridges construction business. It contributes most of the revenue stream and profit for SHRB. Given SDLQ's important business position, SHRB has provided strong funding support to SDLQ for business expansion and maintaining its financial health. SHRB's capacity to provide support is largely underpinned by SDHS. SDHS is the largest toll road operator in Shandong Province, following its merger with Qilu Transportation Development Group Co., Ltd. in November 2020. As of 31 December 2022, SDHG owned a toll road portfolio spanning 7,738 kilometers, of which more than 80% of the operating mileage is within Shandong province. SDHS was the largest SOEs by total assets in Shandong Province and was owned and controlled by the Shandong SASAC. SDHS and its subsidiaries have provided a solid business support to SHRB and SDLQ for years.

## Rating Methodology

The methodology used in this rating is the Rating Methodology for [Engineering and Construction Companies \(December 2016\)](#).

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