

## Credit Opinion

23 August 2023

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

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## Shandong Commercial Group Co. Ltd.

### Surveillance credit rating report

### CCXAP upgrades Shandong Commercial Group Co. Ltd.'s long-term credit rating to BBB<sub>g</sub>, with stable outlook

#### Summary

CCXAP has upgraded the long-term credit rating of Shandong Commercial Group Co. Ltd. ("Lushang Group" or the "Company") to BBB<sub>g</sub> from BBB<sub>g</sub><sup>-</sup>, based on its growth momentum of pharmaceutical business and recovering prospect of retail business. The rating upgrade also reflects its well-diversified business portfolio, which helps effectively diversify business risks and mitigate revenue volatility.

The rating is underpinned by the Company's (1) strong regional competitiveness in retail sector; (2) reasonable product mix and extensive sales network in pharmaceutical business; and (3) good access to both equity and debt capital markets.

The rating also reflects moderate support from the Shandong Provincial Government when necessary, which is based on the Company's (1) strategic importance to shareholders; and (2) good track record of receiving ongoing government support.

However, the rating is also constrained by the Company's (1) decreasing property sales along with slow destocking; (2) weak bottom-line profitability; and (3) high debt leverage and modest liquidity position.

The stable outlook on Lushang Group's rating reflects our expectation that the Company will maintain strong competitiveness in the retail sector in Shandong Province. We also expect that as a state-owned enterprise, it will receive ongoing support from the local government.

## Rating Drivers

- Well-diversified business portfolio to diversify business risks and mitigate revenue volatility
- Strong regional competitiveness in retail sector, with a comprehensive store portfolio
- Reasonable product mix and extensive sales network in pharmaceutical business, with strong growth momentum
- Decreasing property sales along with high geographic concentration and destocking pressure
- Increased revenue with weak profitability
- High debt leverage with large proportion of short-term debts
- Modest liquidity position but partly mitigated by good access to capital
- Proven track record of receiving ongoing support given its strategic importance to shareholders

## Rating Sensitivities

### What could upgrade the rating?

The rating could be upgraded if (1) the Company's business strength and asset quality improves; and (2) the Company's stand-alone credit profile improves significantly, such as improvement in debt structure and leverage.

### What could downgrade the rating?

The rating could be downgraded if (1) the likelihood of government support for the Company decreases; or (2) the Company's stand-alone credit profile weakens significantly, such as deterioration in debt leverage or liquidity.

## Key Indicators

	2020FY	2021FY	2022FY
Total Assets (RMB billion)	117.4	132.8	133.1
Total Equity (RMB billion)	22.5	25.0	25.4
Total Revenue (RMB billion)	35.8	30.1	33.4
Net Profits (RMB billion)	0.2	0.3	0.1
EBIT Margin (%)	5.2	5.9	4.7
Return on Assets (%)	1.7	1.4	1.2
Total Debt/Total Capital (%)	74.8	73.1	71.0
Total Debt/EBITDA (x)	14.6	17.5	16.4
EBITDA/Interest (x)	1.1	1.1	1.3
FFO/Total debt (%)	3.9	4.9	4.3

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

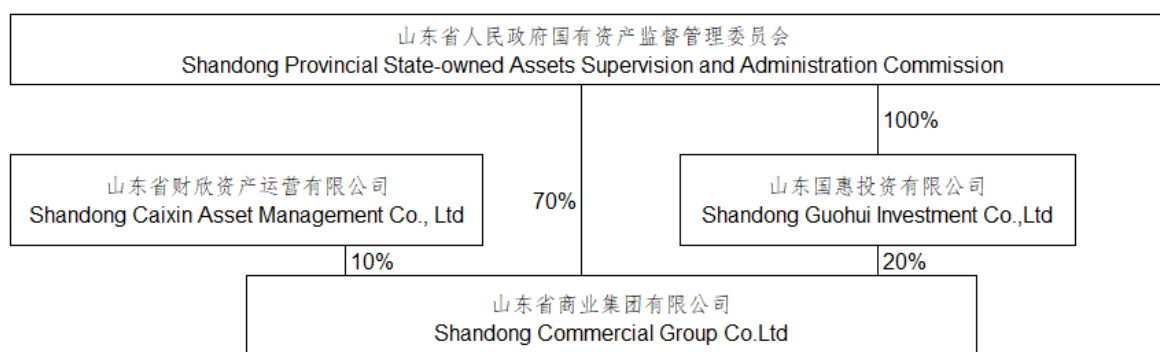
Source: CCXAP research

## Corporate Profile

Founded in 1992, Lushang Group is a state-owned capital investment platform in Shandong Province. The Company mainly engages in retail, health and wellness properties, pharmaceutical, and trading businesses. The Company has three publicly listed subsidiaries, Inzone Group Co., Ltd. ("Inzone Group", Stock Code: 600858.SH), Lushang Freda Pharmaceutical Co., Ltd. ("Freda Pharmaceutical", Stock Code: 600223.SH), and Lushang Life Services Co., Ltd. ("LSFW", Stock Code: 2376.HK). As of 31 March 2023, the Shandong Provincial State-owned Assets Supervision and Administration Commission ("Shandong SASAC") directly held 70% of the

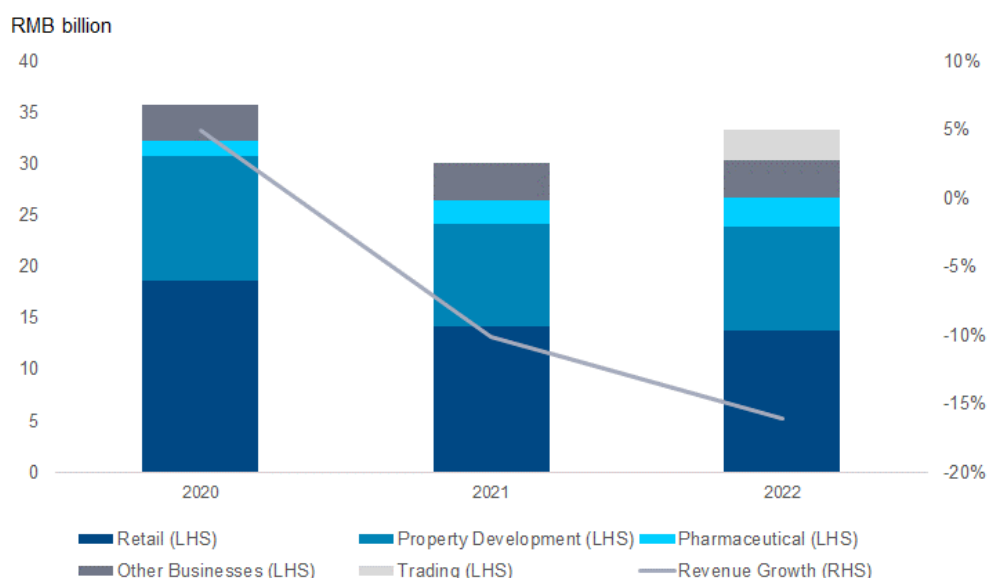
Company's shares and was its ultimate controller, while Shandong Guohui Investment Co., Ltd. and Shandong Caixin Asset Management Co., Ltd, held 20% and 10%, respectively.

### Exhibit 1. Shareholding chart as of 31 March 2023



Source: Company information, CCXAP research

### Exhibit 2. Revenue and revenue growth in 2020-2022



Source: Company information, CCXAP research

## Rating Considerations

### Business Profile

#### Well-diversified business portfolio to diversify business risks and mitigate revenue volatility

Lushang Group is a leading state-owned conglomerate based in Shandong Province. The Company has a diversified business portfolio in multiple industries, mainly including retail, pharmaceutical, and health and wellness properties businesses. The Company also expands its footprints in cultural tourism, education, healthcare, media, financial services and e-commerce, and commodity trading businesses. The Company plans to further expand its business to pre-made food and import and export trade. We believe that the Company can diversify its business risks and mitigate revenue volatility through synergistic operation of its multiple business segments, which is credit positive.

### Strong regional competitiveness in retail sector, with a comprehensive store portfolio

Lushang Group has maintained a strong regional competitiveness in retail sector in Shandong Province, supported by its distinct brand identity and scale advantage in the region. According to data from China Chain Store & Franchise Association, it ranked 2<sup>nd</sup> among chain store operators in Shandong Province in terms of sales volume in 2022. The Company operates a comprehensive store portfolio with six major types of stores, including department store and supermarket complex, shopping center, convenience store, homeware store, electrical appliance store, and automobile franchise store, mainly under the brands “INZONE” and “Uni-Mart”. These stores are located across all 16 municipalities in Shandong Province, as well as nearby cities in Henan Province and Hebei Province.

#### Exhibit 3. Lushang Group’s major types of retail stores as of 31 March 2023

	Number of Stores	Total Area (Thousand sqm)
Department store and supermarket complex	163	3,578.7
Shopping center	5	601.0
Convenient store	212	75.2
Homeware store	6	455.5
Electrical appliance store	57	52.9
Automobile franchise store	5	70.3
<b>Total</b>	<b>448</b>	<b>4,833.6</b>

Source: Company information, CCXAP research

However, Lushang Group's retail business is largely sensitive to economic conditions and external shocks, such as the COVID-19 pandemic and the rapid growth of online shopping. The Company's revenue from the retail business decreased from RMB14.2 billion in 2021 to RMB13.7 billion in 2022. In response, the Company has closed a certain amount of retail shops to improve the operational efficiency. As of 31 March 2023, the Company owned 448 retail shops, with a total area of 4.8 million square meters (“sqm”), reducing from 444 retail shops and 5.2 million sqm as of 31 March 2022. With the ease of the pandemic, the Company will adjust the number of stores in a timely manner, and accelerate its transformation by upgrading retail shops and enhancing its online and offline operations to match the current consumer behavior. We expect the Company's retail business will be recovered with the ease of the pandemic. The Company will also strengthen its brand influence, set up production lines such as pre-made food and logistics and distribution centers. We believe that these measures can alleviate its operating pressure, and Lushang Group can maintain its strong position in Shandong Province.

### Decreasing property sales along with high geographic concentration and destocking pressure

Due to the slowdown of property market in China, Lushang Group's health and wellness properties business has weakened. The Company's contracted sales fell from RMB14.6 billion in 2021 to RMB6.7 billion in 2022; with increased area of completed properties, the Company's revenue from the health and wellness properties business slightly increased from RMB10.0 billion to RMB10.2 billion for the same period. Given the slowdown of the property market, we expect the Company's contracted sales will remain weak in the next 12 to 18 months.

To focus on project destocking and cash collection, the Company has continued to slow down the pace of land acquisition and property construction in 2022. As of 31 March 2023, the Company possessed land reserves with area of 0.6 million sqm, and its new construction starts fell from 1.4 million sqm in 2021 to 0.5 million sqm in 2022. The Company is gradually withdrawing from the property development business through the sales of its land reserves. However, the Company's property projects and land reserves are highly concentrated in

second-tier and third-tier cities in Shandong Province, susceptible to changes in local regulatory policies and economic conditions. In addition, the Company has certain capital expenditure needs for the projects under construction. As of 31 March 2023, the Company had 23 property projects under construction with an estimated uninvested amount of RMB29.9 billion.

### **Reasonable product mix and extensive sales network in pharmaceutical business, with strong growth momentum**

Through Freda Pharmaceutical, Lushang Group engages in the research and development, production, and sale and distribution of a broad range of pharmaceutical and healthcare products. The key products include western and Chinese medicines for neck pain relief and cold treatment, medical supplies, health supplements, chemical raw materials and skincare products, which are sold through an extensive sales and distribution network nationwide. In addition, the Company's skin care ingredients are exported to over 80 countries in North America, the European Union, Japan, and South Korea. We believe that the reasonable product mix and the extensive sales network have reduced the Company's concentration risk in a single product and a single market, which are credit positive.

Benefited by the expansion of online sales channels, Lushang Group's pharmaceutical business continues to thrive. In 2022, the revenue generated from the pharmaceutical business increased by 17.5% YoY to RMB2.8 billion, with a high gross profit margin of 57.1%. The revenue growth is mainly due to the fast growth in the sales of skincare products, which increased by 31.7% YoY to RMB2.0 billion in 2022.

Lushang Group has a proven track record in research and development of pharmaceutical products and had devoted around 9%-12% of its pharmaceutical sales to R&D over the past three years. In 2022, it obtained more than 20 new patents and launched more than 20 new products. The Company also conducts research and development on ingredients for skin care products and is one of the leading hyaluronic acid manufacturers in the world with an average annual output reaching 420 tonnes. As at 31 March 2023, the Group registered 41 patents and applied 67 patents for its skin care products. It invested in Shandong Bausch & Lomb Freda Pharmaceutical Co., Ltd., one of the largest ophthalmic medicine manufacturers in China. In view of its research investment, equity participation, and the acquisition of upstream and downstream enterprises, we expect the Company's competitiveness in the pharmaceutical industry chain will continue to be enhanced.

### **Supplementary income from commodity trading business with rapid expansion**

Lushang Group has participated in commodity trading business since 2022, mainly involving the trading of non-ferrous metals. As a newly engaged business, the commodity trade business is expanding rapidly, with revenue generated from commodity trading business of RMB3.0 billion in 2022, and RMB4.9 billion in 2023Q1. However, the business contributes less to the Company's profit as it is operated under demand-driven model. The business also subjects to high concentration of upstream and downstream. In addition, as commodity trading is a cyclical industry, the business is susceptible to volatility of metal prices and global economic conditions.

## **Financial Profile**

### **Increasing revenue with weak profitability**

Benefited from the newly added commodity trading business, Lushang Group's total revenue increasing from RMB30.1 billion in 2021 to RMB33.4 billion in 2022. In terms of the industry, the retail business remained as the main contributor, accounting for 41.2% of total revenue, followed by health and wellness properties (30.4%),

commodity trading (9.0%), pharmaceutical (8.4%), and others (11.0%). In 2023Q1, trading became the most important revenue contributor, accounting for 39.9% of total revenue.

Lushang Group's profitability remains relatively weak, as reflected by the weak return on assets and EBIT margin. The Company's return on total assets and EBIT margin had both slightly declined, mainly driven by low profitability of the newly added commodity trading business. The profit margin of health and wellness properties, and retail business slightly declined to 15.7% and 31.4% (2021:17.8% and 33.0%), while the pharmaceutical business maintained a relatively high profit margin of 57.1%. The Company's EBIT margin decreased from 5.9% in 2021 to 4.7% in 2022; while the return on assets decreased from 1.4% to 1.2% over the same period. Due to the expanding of operating scale, the Company's period expense ratio (including management fee, marketing fee and finance cost) was 25.0% in 2022, causing a certain profit erosion.

Overall, considering Lushang Group's diversified business portfolio, this could partially support its income over the next 12 to 18 months. However, the Company's profitability is expected to remain relatively weak.

### **High debt leverage with large proportion of short-term debts**

With debt-funded capital expenditure incurred from the expansion of pharmaceutical and health and wellness properties business, Lushang Group's debt leverage has remained at a high level in recent years. As of 31 March 2023, its adjusted total debt (including perpetual debts) amounted to RMB51.3 billion, with a total capitalization ratio of 71.1%. In addition, Lushang Group's debt servicing capability remains weak. Its total debt/EBITDA ratio declined from 17.5x in 2021 to 16.4x in 2022; while the EBITDA/total interest ratio increased from 1.1x to 1.3x over the same period.

In addition, the Company has a high reliance on short-term financing, resulting in large short term debt servicing pressure. As of 31 March 2023, the Company's short-term debt accounted for 63.2% (end-2022: 58.0%) of its total debt. To this end, the Company will take measures to lower debt leverage and adjust the debt structure, such as accelerating the de-stocking of property projects and implementing debt-to-equity swaps.

### **Modest liquidity position but partly mitigated by good access to capital**

Lushang Group has a modest liquidity position. As of 31 March 2023, the Company reported cash reserves of RMB13.2 billion, insufficient to cover its short-term debt of RMB32.4 billion. The large number of short-term debts has exerted high refinancing pressure to the Company. In addition, the Company's operating cash flow has decreased. Its funds from operation ("FFO") decreased from RMB2.7 billion in 2021 to RMB2.2 billion in 2022, accounting for 4.3% of total debt at end-2022.

Lushang Group's liquidity situation could be partially mitigated by its good access to capital as a local state-owned enterprise. The Company has maintained good relationships with financial institutions. As of 31 March 2023, it obtained total credit facilities of RMB45.0 billion with an undrawn amount of RMB22.8 billion. Through holding three listed subsidiaries, the Company has direct access to equity financing channels. The Company can pledge its equity in listed subsidiaries when necessary to provide liquidity buffer. As of 31 March 2023, the Company directly held unpledged equity of about RMB5.7 billion in Inzone Group and Freda Pharmaceutical. Moreover, the Company also has good access to both onshore and offshore capital markets. From 2022 to 2023H1, the Company raised RMB13.6 billion through the onshore market and USD60 million through the offshore market.

### **External Support**

#### **Proven track record of receiving ongoing support given its strategic importance to shareholders**

We assessed the Lushang Group's status, ownership, and control by the Shandong Government as moderate due to its economic and strategic importance to Shandong Province. In 2022, the local government has provided ongoing support to Lushang Group through subsidies and capital injections. In 2022, the local government has provided subsidies of RMB115 million to the Company. In terms of capital injections, the local government injected RMB220 million into the Company from 2022 to mid-2023.

As the state-owned capital investment platform under Shandong SASAC, Lushang Group is primarily engaged in the retail business, which has made social and economic contributions to Shandong Province. However, we assess the Company's financial impact as weak because we believe it accounts for only a small fraction of the total assets of state-owned enterprises controlled by Shandong SASAC.

We considered the Lushang Group's socio-political implications to be moderate as the Company is commissioned by the local government to play an important role in the strategic planning and operation of many major industrial transformation projects and public projects, such as the integration of provincial cultural tourism resources, and the establishment and operation of educational institutions in Shandong Province.

Overall, given Lushang Group's strategic importance to the provincial government, we believe its shareholders will continue to support the Company in the form of government subsidies, capital injections, or asset injections.

## Rating Methodology

The methodology used in this rating is the [Rating Methodology for General Corporate \(April 2019\)](#).

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