Credit Opinion

10 September 2024

Ratings	
Category	Corporate
Domicile	China
Rating Type	Solicited Rating
Long-Term Credit Rating	BBB_g+
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_g+, 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_g+ from BBB_g, based on its continuous business growth and improving market position in the retail sector in Shandong Province. The rating upgrade also reflects its well-diversified business portfolio, which helps effectively diversify industry risks and mitigate revenue volatility.

The long-term credit rating is underpinned by the Company's (1) well-diversified business portfolio to diversify business risks and mitigate revenue volatility; (2) leading market position in retail sector, with comprehensive store portfolio; and (3) good branding in cosmetic and pharmaceutical business, with online-and-offline distribution channels.

However, the rating is also constrained by the Company's (1) high geographic concentration and destocking pressure in property business; and (2) high debt leverage and moderate credit metrics; and (3) moderate liquidity position.

The rating also reflects moderate support from the Shandong Provincial Government when necessary, which is based on the Company's (1) direct and full ownership by the provincial government; (2) strategic importance to its shareholders; and (3) good track record of receiving ongoing government support.

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
- Leading market position in retail sector, with comprehensive store portfolio
- High geographic concentration and destocking pressure in property business
- Good branding in cosmetic and pharmaceutical business, with online-and-offline distribution channels
- Increased revenue with weak assets profitability
- High debt leverage and moderate credit metrics
- Moderate liquidity position but partly mitigated by good access to capital
- Good track record of receiving ongoing government support

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

	2021FY	2022FY	2023FY	2024H1
Total Assets (RMB billion)	132.8	133.2	129.0	132.4
Total Equity (RMB billion)	25.0	25.4	24.2	24.3
Total Revenue (RMB billion)	30.1	33.4	46.3	24.0
Net Profits (RMB billion)	0.3	0.1	0.1	0.3
EBIT Margin (%)	5.9	4.7	3.0	-
Return on Assets (%)	1.4	1.2	1.1	-
Total Debt/Total Capital (%)	73.1	70.9	70.9	68.3
Total Debt/EBITDA (x)	17.5	16.4	16.5	-
EBITDA/Interest (x)	1.1	1.3	1.2	-
FFO/Total debt (%)	4.9	4.3	4.3	-

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

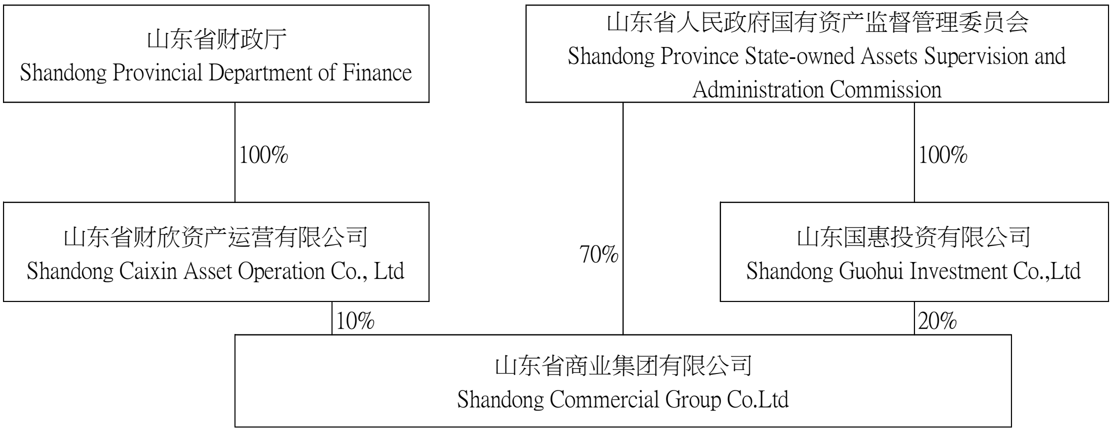
Source: Company data, CCXAP research

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 2024, the Shandong Provincial State-owned Assets Supervision and Administration Commission ("Shandong SASAC") directly held 70% of the

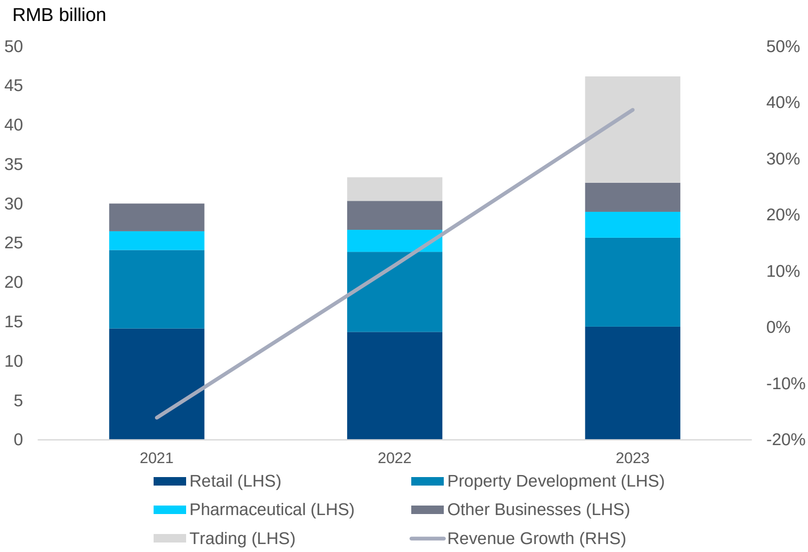
Company's shares and was its ultimate controller, while Shandong Guohui Investment Co., Ltd. and Shandong Caixin Asset Management Co., Ltd, held 20% and 10%, respectively.

Exhibit 1. Shareholding chart as of 31 March 2024



Source: Company information, CCXAP research

Exhibit 2. Revenue and revenue growth in 2021-2023



Source: Company information, CCXAP research

Rating Considerations

Business Profile

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

According to the ranking released by Shandong SASAC, Lushang Group is one of the top 10 provincial state-owned companies based in Shandong Province. The Company has a well-diversified business portfolio, entering into industries including retail, pharmaceutical, health and wellness properties, commodity trading businesses. The Company also expands its footprints in cultural tourism, education, healthcare, media, financial services, e-commerce 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.

Leading market position in retail sector, with comprehensive store portfolio

Lushang Group has demonstrated a leading market position in Shandong Province's retail sector, supported by its distinct brand identity and scale advantage. According to data from China Chain Store & Franchise Association, it ranking rose to 1st in 2023 from 2nd in 2022 among chain store operators in Shandong Province in terms of sales volume. 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 17 municipalities in Shandong Province, as well as cities in Henan Province, Hebei Province and Beijing. As of 31 March 2024, the Company owned 455 retail shops, with a total area of 4.7 million square meters ("sqm"), rising from 448 retail shops as of 31 March 2023.

Exhibit 3. Lushang Group's major types of retail stores as of 31 March 2024

	Number of Stores	Total Area (Thousand sqm)
Department store and supermarket complex	175	3,517.3
Shopping center	5	601.0
Convenient store	206	73.3
Homeware store	6	455.5
Electrical appliance store	58	52.8
Automobile franchise store	5	70.3
Total	**455**	**4,770.2**

Source: Company information, CCXAP research

Lushang Group's retail business is sensitive to economic conditions and market changes, such as the rapid increasing trend of online shopping. The Company has taken several measures to cater to market demand and improve its competitiveness. Lushang Group has diverse retail store portfolio, including department store and supermarket complex, shopping center, convenient store, homeware store, electrical appliance store, and automobile franchise store, which can satisfy different retail demands. Lushang Group has also collaborated with ByteDance and Kuaishou to broaden its online channels. As a result, the Company's revenue from the retail business increased from RMB13.7 billion in 2022 to RMB14.4 billion in 2023, with profit margin increasing from 31.4% in 2022 to 33.7% in 2023. The Company will adjust the number of stores and improve profitability in a timely manner through upgrading retail shops and combining its online and offline channels to suit customer behavior changes. Moreover, the Company has strengthened its brand influence by establishing 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 leading market position in Shandong Province.

Good branding in cosmetic and pharmaceutical business, with online-and-offline distribution channels

Through Freda Pharmaceutical, Lushang Group engages in the research and development, production, sale and distribution of a broad range of cosmetic products, pharmaceutical and healthcare products. Benefited by the expansion of online sales channels, Lushang Group's pharmaceutical business continues to thrive, with revenue rose by 18.7% from RMB2.8 billion in 2022 to RMB3.3 billion in 2023, with a high gross profit margin of 57.6%. Fast growth was mainly driven by sales increase in cosmetic products, with cosmetics contributing 72.7% of this sectors' revenue in 2023.

Pharmaceutical products are sold through extensive sales and distribution network nationwide. In addition, the Company's skin care ingredients are exported to over 80 countries in Australia, North America, the European Union, Japan, and South Korea, achieving high reputation among customers. 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.

Lushang Group attaches great importance to the research and development of pharmaceutical products, and has proven track record of spending around 10% of its pharmaceutical sales to R&D over the past three years. The Company has obtained 276 patents since establishment and launched 152 new products over the past three years. 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. Freda Pharmaceutical also invested in Shandong Bausch & Lomb Freda Pharmaceutical Co., Ltd., one of the largest ophthalmic medicine manufacturers in China. Considering its continuous in research investment, joint venture, and the acquisition of industry-chain enterprises, we expect the Company's competitiveness in the pharmaceutical industry chain will continue to be strengthened.

High geographic concentration and destocking pressure in property business

Since 2021, affected by the slowdown of property market, the Company slowed down the land investment and business expansion, and the contracted sales dramatically decreased. Due to the introduction of supportive policies in property market, the Company's contracted sales increased from RMB6.7 billion in 2022 to RMB7.3 billion in 2023. With increased area of completed properties, the Company's revenue from the health and wellness properties business slightly increased from RMB10.2 billion to RMB11.3 billion for the same period, with profit margin decreasing from 15.7% in 2022 to 9.8% in 2023. Considering that the real estate market has not fully recovered, we expect the Company's contracted sales will remain weak in the next 12 to 18 months.

To focus on project construction and land destocking, the Company has continued to slow down the pace of land acquisition in 2023. The Company has been actively seeking for land buyers and increasing its new project construction for destocking. Its newly construction projects rose from 0.5 million sqm in 2022 to 0.9 million sqm in 2023. As a result, the Company's land reserves decreased from 0.6 million sqm to 0.5 million sqm over the same period. Besides, 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 property market conditions. Furthermore, the Company has certain capital expenditure pressure for the projects under construction. As of 31 March 2024, the Company had 22 property projects under construction with an estimated uninvested amount of RMB25.8 billion.

Rapid expansion from commodity trading business

Lushang Group has participated in commodity trading business since 2022, mainly involving the trading of non-ferrous metals. The commodity trade business expanded rapidly since establishment, with revenue generated from commodity trading business increased from RMB3.0 billion in 2022 to RMB13.5 billion in 2023. However, the business contributes less to the Company's profit as it is operated under demand-driven model. However, the Company has high reliance on top five suppliers and customers, which causes high concentration risk. 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 rapid growth in commodity trading business and continuous growth in retail sector, Lushang Group's total revenue increasing from RMB33.4 billion in 2022 to RMB46.3 billion in 2023. In terms of the industry, the retail business remained as the main contributor, accounting for 31.1% of total revenue, followed by commodity trading (29.2%), health and wellness properties (24.5%), pharmaceutical (7.2%), and others (8.0%). The overall gross profit margin decreased from 27.8% in 2022 to 20.0% in 2023.

However, Lushang Group's profitability remains weak, as reflected by the weak return on assets and EBIT margin. The Company's return on total assets and EBIT margin had both declined over the past year, mainly driven by low gross profit margin of commodity trading business (0.1%), and the decline profit margin of property development business. The profit margin of property development declined to 9.8% in 2023 from 15.7% in 2022, mainly due to the low profit margin of Lushang garden projects. The pharmaceutical business maintained a relatively high profit margin of 57.8% in 2023. The Company's EBIT margin decreased from 4.7% in 2022 to 3.0% in 2023; while the return on assets also slightly decreased from 1.2% to 1.1% over the same period. However, the Company's period expense ratio (including management fee, marketing fee and finance cost) declined from 24.0% in 2022 to 16.8% in 2023, indicating more efficient cost management.

Overall, considering Lushang Group's diversified business portfolio and continuously expansion from retail and commodity trading sector, its income would continue to increase over the next 12 to 18 months. However, the Company's profitability is expected to remain relatively weak due to business nature of commodity trading.

High debt leverage and moderate credit metrics

With continuous funding for its expansion 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 December 2023, its adjusted total debt (including perpetual debts) amounted to RMB50.5 billion, with a total capitalization ratio of 70.9%. In addition, Lushang Group's debt servicing capability remained relatively weak, its total debt/EBITDA ratio slightly increased from 16.4x in 2022 to 16.5x in 2023; while the EBITDA/total interest ratio slightly decreased from 1.3x to 1.2x over the same period.

In addition, the Company still has large reliance on short-term financing, resulting in large short term debt repayment pressure. As of 31 December 2023, the Company's short-term debt ratio increased to 68.6% from 63.7% at end-2022. Given the Company's large expenditure pressure from the construction projects in the pipelines and its acquisition appetite, we expect that its debt leverage will remain at a relatively high level in the next 12 to 18 months.

Moderate liquidity position but partly mitigated by good access to capital

Lushang Group has moderate liquidity position. As of 31 March 2024, the Company reported cash reserves of RMB14.8 billion, insufficient to cover its short-term debt of RMB34.9 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 remained same level and its funds from operation ("FFO") remained at RMB2.2 billion in 2023, accounting for 4.3% of total debt at end-2023.

Lushang Group's liquidity situation could be partially mitigated by its good access to multiple financing channels. The Company has maintained good relationships with large financial institutions. As of 31 March 2024, it obtained total credit facilities of RMB49.7 billion with an unused amount of RMB25.0 billion. Through holding three listed subsidiaries, the Company also has direct access to equity financing channels. The Company can pledge its equity in listed subsidiaries when necessary to provide liquidity cushion. As of 31 March 2024, the Company directly held unpledged assets of about RMB4.6 billion. Moreover, the Company also has good access to both onshore and offshore capital markets. From 2023 to August 2024, the Company raised RMB14.8 billion through the onshore market, as well as USD130.0 million and RMB485.0 million through the offshore market. Since 2024, the Company also actively issue mid to long term bonds in the onshore market to adjust its debt structure, with a total issuance amount of RMB2.5 billion in the first eight months of 2024, with 3-5 years' maturity.

External Support

Good track record of receiving ongoing support

We assessed the Lushang Group's status, ownership, and control by the Shandong Government as moderate due to its high importance in economic development in Shandong Province. The local government has provided ongoing support to Lushang Group in forms of capital injection and financial subsidy. The local government injected RMB150.0 million of cash into the Company and provided government subsidy of RMB92.9 million in 2023.

As the important strategic investment and financing, industrial integration and venture capital investment platform under Shandong SASAC, Lushang Group is primarily engaged in the retail business, which has made great social and economic contributions to the region. However, we access 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 Shandong 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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