Credit Opinion

8 February 2024

Ratings	
Senior Unsecured Debt Rating	BBB_g-
Long-Term Credit Rating	BBB_g-
Outlook	Stable
Category	Corporate
Domicile	China
Rating Type	Solicited Rating

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Shandong Honghe Holding Group Co., Ltd

Initial credit rating report

CCXAP assigns first-time long-term credit rating of BBB_g- to Shandong Honghe Holding Group Co., Ltd, with stable outlook.

Summary

The BBB_g- long-term credit rating of Shandong Honghe Holding Group Co., Ltd ("SHHG" or the "Company") is underpinned by the Company's (1) status as a major coal mining company in Zoucheng City; (2) stable coal mining and trading business supported by solid and diversified demands; and (3) ongoing revenue growth and good profitability.

However, the rating is also constrained by the Company's (1) earnings vulnerable to energy prices and industry policy adjustments; (2) small scale of coal mining production and reserves; (3) relatively high debt leverage and weak asset liquidity; and (4) a moderate liquidity profile with limited credit facilities.

The rating also reflects SHHG's high likelihood of receiving strong support from its parent, Zoucheng Urban Assets Holding Group Co. Ltd ("ZCUA"), the largest local infrastructure investment and financing company ("LIIFC"), which mainly engages in the infrastructure construction in Zoucheng City. The high likelihood of parent support based on the Company's (1) unique position as the sole coal mining subsidiary of ZCUA; (2) status as a key revenue and profit contributor of ZCUA; (3) cross-default clauses associated with the offshore bond issuances of ZCUA.

The stable outlook on SHHG's rating reflects our expectation that the Company will maintain its good regional competitiveness in the coal mining business in Zoucheng City over the next 12-18 months.

Rating Drivers

- Major coal mining company in Zoucheng City with a concentration in coal mining and trading
- Earnings vulnerable to energy prices and industry policy adjustments
- Stable coal mining and trading business supported by solid and diversified demands
- Small-scale coal mining production and reserves
- Relatively high debt leverages due to business expansion
- Moderate liquidity profile with limited credit facilities
- Strategic importance to its parent and local government

Rating Sensitivities

What could upgrade the rating?

The rating could be upgraded if (1) commodity prices rise substantially, further boosting the Company's profits; (2) the Company's market position strengthens with a material increase in product output; (3) the Company demonstrates lower debt leverage and improved liquidity position and (4) strong parent-subsidiary linkage with ZCUA.

What could downgrade the rating?

The rating could be downgraded if (1) commodity prices fell sharply, adversely affecting the Company's earnings; (2) the Company's total debt level rose sharply; (3) the Company demonstrates deteriorated credit metrics and weakened liquidity profile and (4) less parent-subsidiary linkage with ZUCA.

Key Indicators

	2020FY	2021FY	2022FY
Total Assets (RMB billion)	12.6	13.7	14.3
Total Equity (RMB billion)	6.0	6.4	6.9
Total Revenue (RMB billion)	3.9	4.6	5.4
Net Profits (RMB billion)	0.2	0.4	0.4
EBIT/Revenue (%)	11.5	12.6	14.3
EBIT/Average Assets (%)	3.6	4.4	5.6
Total Debt/Total Capital (%)	40.3	42.6	45.8
Total Debt/EBITDA (x)	6.5	6.4	5.9
EBIT/Interest (x)	1.9	2.2	1.9
(CFO-Dividend)/Total Debt (%)	2.6	4.0	2.7

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

Source: Company data, CCXAP research

Corporate Profile

Founded in 1998, SHHG is a major coal mining and trading company in Zoucheng City of Shandong Province. In addition to coal-related business, the Company also engages in heating supply, limestone sales, and ecological agriculture business. As of 30 September 2023, the Company was wholly owned by ZCUA, the largest LIIFC by asset scale in Zoucheng City; and it is ultimately controlled by the State-owned Asset Supervision and Administration Bureau of Zoucheng City ("Zoucheng SASAB").

Exhibit 1. Revenue structure in 2023Q3

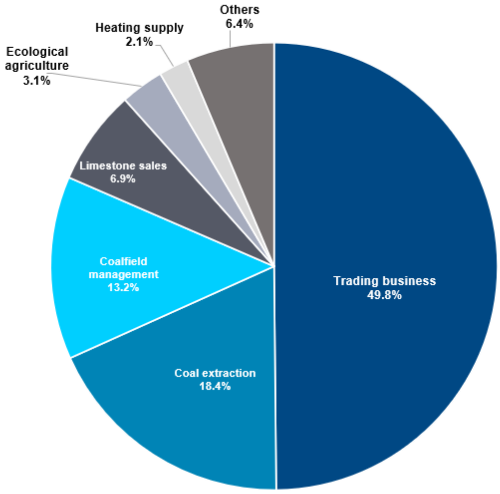
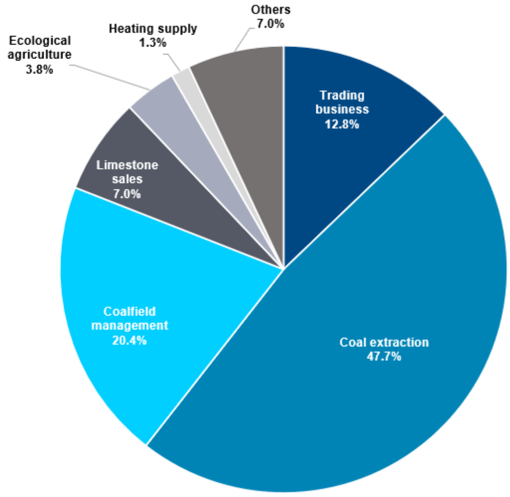


Exhibit 2. Gross profit structure in 2023Q3



Source: Company information, CCXAP research

Exhibit 3. Shareholding Chart as of 30 September 2023

Source: Company information, CCXAP research

Rating Considerations

Major coal mining company in Zoucheng City with a concentration in coal mining and trading

The largest coal mining company in Zoucheng City is Yankuang Energy Group Company Limited ("Yankuang Energy"), specializing in the production of thermal coal. Yankuang Energy is a subsidiary of Shandong Energy Group Co., Ltd, with its ultimate parent being the Shandong State-owned Assets Supervision and Administration Commission. SHHG is a significant local state-owned enterprise in Zoucheng City that also engages in the thermal coal business. It is recognized as an outstanding enterprise in the national coal industry and has been listed among the top 100 coal industry enterprises in China for multiple years. As of 30 September 2023, the Company derives profits mainly from coal mining, trading, and coalfield management business.

Earnings vulnerable to energy prices and industry policy adjustments

As a coal mining and trading company, SHHG's earnings are subject to various factors such as seasonal demand changes, weather conditions, and energy policies.

In China, despite the government's efforts on energy transition in recent years, coal remains a primary source of energy consumption. The downstream industries associated with coal consumption span various sectors, including power generation, steel production, cement manufacturing, and chemical engineering.

According to data from the National Bureau of Statistics, the overall production of raw coal in 2023 reached 4.66 billion tons, marking a year-on-year growth of 2.9%. However, the growth rate significantly decelerated compared to 2022 (which saw year-on-year growth of 9%), mainly due to the declining raw coal price and tighter security checks on the coal mine.

In 2022, the price of thermal coal had been maintained at a high level and saw several rounds of rise. In the first quarter, due to the seasonal energy demands and the Russia-Ukraine conflicts, the price of thermal price saw a first-round increase. Though the price fell in the second quarter of 2023 due to the end of the heating peak season, the price was supported by the non-electricity demands and the tight supply due to pandemic restrictions. In October, Jingtang Port Thermal Coal Closing Price Index (Q5500K) rose above RMB1,600 per ton, representing a growth of over 100% as compared to the lowest level within the year.

In 2023, the coal industry was impacted by continued coal supply security policies, resulting in a slight decline in the closing prices of thermal coal. China's Thermal Coal 5,500 kcal in port Qinghuangdao Index slightly declined from RMB735 per ton at the beginning of 2023 to RMB730 per ton in January 2024. Meanwhile, the domestic consumption of coal has been resilient. As of 31 October 2023, China's production of thermal coal stood at 3.1 billion metric tons, showing a modest year-on-year growth of 1.5%. Meanwhile, the annual consumption reached 3.3 billion metric tons, demonstrating a notable increase of 7.4% compared to the previous year. The consumption growth rate not only experienced a significant improvement from the previous year but also surpassed the growth rate of production noticeably.

The nationwide increase in commodity prices has led to higher raw material costs, significant increases in employee wages, and an overall rise in production costs due to enhanced coal mine security measures. Additionally, various taxes and fees, such as resource taxes, have also increased. These costs increase in this particular area and are expected to be largely irreversible in the short term. As a result, we believe the downward potential of coal prices is limited in 2024.

Small scale of coal mining production and reserves

The Company has relatively low coal mining and recoverable reserves, and there is some uncertainty surrounding the construction of backup coal mines. The average annual coal mining of the Company from 2020 to 2022 was 1.4 million tons, which is relatively small compared to the industry average. As of 30 September 2023, the combined remaining recoverable reserves of the Company's two operating coal mines are relatively limited. Although the Company has acquired certain coal resource reserves through purchases and allocations, investment in the exploration of reserve coal mines has been temporarily suspended due to a lack of substantial progress. The timing of future development remains uncertain.

Exhibit 4. Production capacity and reserve coalfield as of 30 September 2023

In million tons	Actual output	Remaining recoverable reserves
Henghe Coalfield (In operation)	0.5	4.8
Hongqi Coalfield (In operation)	0.5	19.8
Xiaomeng Coalfield (Backup coalfield)	-	74.3
Pandian Coalfield (Backup coalfield)	-	46.4
Total	**1.0**	**145.3**

Source: Company information, CCXAP research.

Stable coal mining and trading business supported by solid and diversified demands

We assess the Company's coal mining business is stable. In light of the fluctuations in coal prices, the Company employs coal-washing processes to enhance the value of its products and expand profit margins during periods of low coal prices. However, when coal prices rise and demand exceeds supply, the Company refrains from coal washing and directly sells the coal to external parties to boost revenue. The Company's primary sales regions are within Shandong Province. The downstream customers primarily consist of small and medium-sized coal trading companies, local power plants, and chemical plants. During the peak sales season, the Company primarily sells to coal trading companies that offer relatively higher purchase prices. In the off-peak sales season, the remaining coal is purchased by regional power plants to ensure smooth coal circulation. Supported by the strong downstream demands and agile business model, the Company is able to sell most of its coal extracted as reflected by its sustainably high proportion of products sold in the past few years.

Trading business is the largest contributor to the Company's revenue, of which coal trading accounted for around 75.6% of the segment revenue as of 2023Q3. By utilizing its competitiveness and regional significance, the Company is able to consolidate the demands of downstream customers regarding coal quantity and quality by leveraging its channels. As a result, the Company can secure coal supply via bulk purchasing at a price lower than the prevailing market prices. We assess the risk of this segment as low, as the Company adopts a demand-driven procurement strategy to avoid excessive accumulation of inventory and additional storage costs. Meanwhile, the concentration in both upstream and downstream enterprises has been decreasing over the years, and we believe the concentration risks on both ends are now moderate. As of 30 September 2023, the Company's top 5 suppliers accounted for 36.3% of the total procurement amount while the top 5 customers accounted for 37.2% of the total sales revenue.

Meanwhile, in the first three quarters of 2023, the coal trading business recorded a revenue of RMB2.0 billion while the coal mining segment recorded a revenue of RMB0.8 billion, implying that the Company relies more on coal procurement rather than self-owned coalfield to boost overall revenue. As a result, we assess the Company's reliance on raw material procurement is high. Besides, though being the largest revenue contributor, the trading business only contributed 12.8% of total gross profit by 30 September 2023 due to a relatively low bargaining position with downstream customers.

Exhibit 5. Sales of coal mining business from 2021 to 2023Q3

	2021FY	2022FY	2023Q3
Average selling price (RMB/Ton)	785.0	705.3	697.3
Sales volume (million tons)	1.2	1.4	1.1
Revenue (RMB in million)	948.9	957.2	754.4
Sell-through rate (Volume sold/volume produced in a given period, %)	98.2	98.8	102.8

Source: Company information, CCXAP research.

In addition to traditional coal mining and trading business, the Company also conducts coalfield management business. The business model is that the Company primarily provides technical and managerial support without having ownership of the coal mine or control over the products. The managerial support by the Company includes personnel training, construction planning, safety management, and coal sales. As a value-added service, the gross margin of coalfield management is relatively high as compared to other segments of the Company. The gross profit of this segment has seen a stable increase over the past few years, from RMB7.9 million in 2020 to RMB184.0 million in the first three quarters of 2023.

Supplementary income from other businesses

Apart from the coal business, the Company also engages in other non-coal business, including ecological agriculture, heating supply, and limestone sales. These businesses contribute less to the Company's overall revenue and profits. In the first three quarters of 2023, non-coal businesses contributed revenue of RMB757.1 million and gross profit of RMB145.5 million, accounting for 18.5% of total revenue and 16.1% of total gross profit, respectively.

The ecological agriculture business is mainly about utilizing microbial fermentation and other methods to produce yeast, seasoning powder, and feed products. Its current customer base mainly consists of food trading companies and food production enterprises. We assess the sustainability of this segment as low. In 2021, the yeast product manufacturing facility with an annual production capacity of 15,000 tons was transferred to Angel Yeast (Ji Ning) Pte Ltd. The future development of the current project (Phase II project of Saint Qi Modern Agricultural Biotechnology Park) faces uncertainty, hence there is impairment risk associated with the ongoing project. As of 30 September 2023, the project has a total investment amount of RMB1.0 billion and an outstanding amount of RMB0.5 billion.

Good profitability benefiting from overall coal market condition

From 2020 to 2022, SHHG's after-tax profit rose from RMB229.6 million to RMB413.8 million, thanks to the robust performance of the overall coal market and the Company's competitive presence in the local market. The main growth engines of the revenue growth were the coal trading business and the coalfield management business. As of 2023Q3, the gross margins of its coal business are satisfactory, with the trading business, coal mining, and coalfield management business recorded at 5.7%, 57.0% and 34%, respectively. Its EBIT margin increased from 11.5% in 2020 to 14.3% in 2022, and its cash flow from operation ("CFO") increased from RMB105.4 million in 2020 to RMB261.3 million as of 2023Q3. Meanwhile, the return on assets has fluctuated as the ratio recorded 7.1%, 4.4%, and 5.6% from 2020 to 2022.

Relatively high debt leverage with certain debt repayment pressure

Due to the industry nature, coal mining enterprises generally have a high debt leverage. As of 30 September 2023, the Company's total capitalization ratio increased to 47.1% in 2023Q3 from 40.3% in 2020, and the debt/asset ratio stood at 51.0% as of 2023Q3, compared to 52.3% in 2020.

Meanwhile, its total debt amounted to RMB6.1 billion as of 30 September 2023 from RMB4.1 billion in 2020. The rise of total debt was primarily attributed to the spending on fixed assets and intangible assets, such as land use rights. The short-term debt/total debt declined from 62.6% in 2020 to 49.9% as of 2023Q3, which implies the debt structure has improved. Nevertheless, it should be noted that the decline in the weight of short-term debt is a result of the repayment of short-term borrowings and an increase in long-term borrowings, the amount of total debt has increased as a result of the increase in long-term borrowings.

We assess the Company has certain debt repayment pressure as reflected by its EBIT/interest expense and (CFO- dividends)/total debt. Its EBIT/interest expense ratio has been at a low level, ranging between 1.9x to 2.2x from 2020 to 2022. The (CFO- dividends)/total debt ratio has also been weak, which was 2.7% in 2022. Hence, we believe that the Company is weak in terms of debt servicing capability.

Moderate liquidity profile

As of the end of September 2023, the Company has obtained a total bank credit line of RMB2.2 billion, with an unused limit of RMB292.0 million. The available credit facility is relatively small compared to the Company's business scale and total debt. In contrast, around 66.0% of the Company's interest-bearing debt is debt financing as of 30 September 2023. Up to now, the Company has launched several bond issuances on the onshore market, with coupon rates ranging from 5% to 7%, a level we believe to be moderate. The high reliance on the bond market exposed the Company to a high market interest rate risk.

External Support

Strategic importance to its parent and local government

As the core subsidiary of ZCUA, the Company has a high likelihood of receiving strong support from ZCUA and Zoucheng SASAB when necessary.

The Company is the only subsidiary engaging in coal mining and trading business under ZCUA. The financial impact of SHHG's default is material. As of 30 September 2023, SHHG recorded a revenue of RMB4.1 billion while the revenue of ZCUA was MB6.5 billion. The after-tax profit of SHHG was RMB306.6 million while that of ZCUA was RMB221.6 million. Hence, the Company is a unique subsidiary and a key contributor to the ZCUA's profitability.

ZCUA has provided a total guarantee of around RMB990 million to SHHG. Besides, there are cross-default clauses associated with 5 offshore bonds (the total amount issued is RMB1.4 billion) issued by ZCUA. We believe that should a credit event of SHHG occur, the probability of default on ZUCA's offshore debt may rise significantly.

Zoucheng Municipal Government has provided strong support in terms of preferential policies and subsidies. So far, Zoucheng Municipal Government has implemented a series of supportive policies for SHHG, taking the lead in the relocation work of Xingcun in Honghe Mining Coal Mining Area, coordinating cooperation matters between Honghe Group and Yankuang Energy, and gradually resolving issues related to mandatory external guarantees and advance funding for SHHG.

Therefore, we believe the Company will remain an important state-owned enterprise and will not easily be replaced in the coming 12 to 18 months.

Structural considerations

SHHG's senior unsecured debt rating is equivalent to its long-term credit rating. We believe that parent support will flow through the Company given its strategic importance to its parent company, thereby mitigating any differences in an expected loss that could result from structural subordination.

Rating Methodology

The methodology used in this rating is the Rating Methodology for Mining Industry (December 2017).

A credit rating is the analytical result of current credit worthiness and forward-looking opinion on the credit risk of a rated entity or a debt issue. Credit ratings issued by CCXAP are opinions on the current and relative future credit risk of the rated entities or debt issues, but do not address any other risks, including but not limited to liquidity risk, market price risk, and interest rate risk.

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