Asia Credit Research

OCBC Bank

Century Sunshine Group: Credit Update

Thursday, 29 September 2016

Avoiding Indigestion

- Proposed acquisition could offer additional scale and potential synergies with CSG's existing fertilizer business. Some execution risks exist.
- Shift in product mix would likely pressure margins, while working capital needs would strain on operating cash flow. The former would pressure interest coverage, while the latter can be sustained with CSG's current large cash balance.
- In aggregate, CSG has the balance sheet to absorb the acquisition, with pro-forma net gearing remaining in the teens. **We will reiterate our Neutral Issuer Profile and Overweight on the CENSUN'18s**.

- **Distressed acquisition**: Century Sunshine Group Holdings Limited ("CSG") announced on 04/08/16 of its intention to acquire a 50.5% equity interest in Shandong Hongri Acron Chemical Joint Stock Company Ltd ("Hongri Acron"). Hongri Acron is a distressed compound fertilizer company based in the PRC. Transaction details include the consideration of USD1 for the stake, as well as the agreement to provide up to RMB250mn worth in financial assistance to Hongri Acron. We provided our initial thoughts[1] when the deal was first announced. Since then CSG had announced its 1H2016 results[2] as well as provided a shareholder circular (filed to the HKSE on 27/09/16) over the deal, given that an EGM is required for the deal to go through. Though the EGM approving the acquisition will not be held till 19/10/16, given the new release of information via the shareholder circular, we will be reviewing the potential impact of the deal on bondholders in this report.

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Recent Performance

- **Fertilizer segment faced volume growth, but ASP pressure**: For 1H2016 performance, CSG's revenue was flattish, up 2.7% y/y to HKD1.24bn, partly due to the slump in RMB (CSG's operating currency) versus HKD (CSG's reporting currency). The fertilizer business was pressured during the period, with segment revenue falling 6.2% y/y to HKD682.0mn. Comparatively the fertilizer segment grew by 21.4% y/y in 2015. Management has indicated that though fertilizer sale volumes increased 8.3% y/y to 321,847 tonnes, segment revenue was pressured by the fall in ASP from HKD2,447 per tonne to HKD2,119 per tonne (13.4% decline). Management indicated that the prices of compound fertilizers have suffered from market fluctuation and fell by 10.6% during the period. CSG was able to defend its fertilizer gross margins however, with segment gross margin decreasing slightly to 27.6% (1H2015: 28.5%). This was due to the fall in raw material prices and CSG's cost control measures. It is worth noting that fertilizer market leader Sinofert saw its sale volumes fall 35.8% y/y during 1H2016, citing continued pressure from the overcapacities in the China fertilizer market.

[1] OCBC Asian Credit Daily - 08 August 2016
[2] OCBC Asian Credit Daily - 1 September 2016

- **Trading segment squeezes Magnesium margins**: The magnesium products segment continues to grow with revenue up 11.8% y/y to HKD424.4mn. Demand was strong, with volume up 43.2% y/y to 16,013 tonnes. However, there was a sharp 22.1% decrease in ASP to HKD25,510 per tonne (1H2015: HKD32,768 per tonne). The reason for the sharp increase in volume and decline in ASP was due to CSG starting the magnesium products trading business during the period, which sharply increased (+76% y/y) the volume of basic magnesium products (more commoditized, low margin products versus rare earth magnesium alloys) sold. The shift in product mix also caused segment gross margin to decline sharply to 30.7% (1H2015: 34.9%). In aggregate, CSG still considers downstream demand (such as for transportation usage) for magnesium alloys to be strong, and continues to ramp up production at its Xinjiang acquisition.

- **FX losses and increased financing costs impacted net profit**: With both operating segments seeing margin pressure, CSG's group gross margin compressed by 2.2ppt to 30.0%. The lower gross profit, coupled with HKD37.9mn in FX losses and HKD22.2mn increase in finance costs (due to additional borrowings) caused pre-tax profit to fall 27.1% y/y to HKD203.7mn. Despite the fall in profits, CSG managed to increase cash generated from operating activities from HKD133.9mn (1H2015) to HKD397.3mn (1H2016), mainly via the stretching of its trade and other payables (increased HKD167.5mn during 1H2016).

- **Liquidity and leverage profile robust pre-acquisition**: Interest coverage worsened slightly from 6.9x (end-2015) to 4.9x (end-1H2016) due to the increase in interest expense (from higher borrowings). As such, there remains interest coverage covenant headroom compared to the 3.0x required. Cash balance increased by HKD351.1mn (versus end-2015) to HKD1.80bn. This was largely driven by the HKD289.4mn increase in borrowings. As CSG has HKD1.79bn in total borrowings and HKD1.80bn in cash, CSG is currently a net cash company. On a gross gearing basis, it has increased from 45% (end-2015) to 57% (end-1H2016). Though CSG continues to hold significant amounts of cash, we note that CSG will continue to expand its production facilities for both the fertilizer segment (the greenfield facility at Ruichang City, Jiangxi, with phase 1 operational in 2018) as well as its magnesium segment (the recently acquired Xinjiang facilities). In addition, CSG would likely require capital as well to turnaround Hongri Acron.

Summary of Acquisition Deal Terms

CSG will be paying a token consideration of USD1 for 50.5% of Hongri Acron (the balance will be held by independent third parties). In addition, as part of the acquisition agreement, CSG will be providing up to RMB250mn (~HKD292.5mn) in financial assistance (via corporate guarantees, provision of collateral) to Hongri Acron. This RMB250mn can only be used for 1) repayment of RMB20.3mn to one of Hongri Acron's clients for sums due end-2016 2) the balance to be used for working capital only. The long-stop date for the transaction is 02/08/17 though we suspect deal completion will occur sooner as the RMB20.3mn in financial assistance for repayment has to be met by 25/12/16.

As the transaction constitutes a major transaction (Chapter 14 of Listing Rules), an EGM has to be held for shareholder approval and it is currently scheduled for the 19/10/16. With the founder, Mr Chi Wen Fu, controlling 33.7% of CSG, and with Mr George Yang abstaining (7.5% of CSG), CSG would only need to convince minority shareholders holding ~12.6% of CSG to get approval for the acquisition. As such, we expect approval for the acquisition to go through.

Upon completion, Hongri Acron's financial performance will be consolidated into

CSG's financial statements, given CSG's 50.5% ownership. We will review the potential impact on CSG's financials in subsequent sections.

Acquisition Positives

- **Operational synergies**: Hongri Acron will essentially be a bolt-on acquisition for CSG's fertilizer segment. For example, CSG generated HKD1.52bn in fertilizer segment revenue in 2015, while Hongri Acron generated HKD1.78bn in total revenue. Hongri Acron has an estimated annual capacity of 820,000 tonnes for NPK compound fertilizers (at its facilities in Shandong). Comparatively, CSG's existing production facilities at Jiangsu (both organic and compound fertilizers) are expected to reach 850,000 tonnes by the end of 2016. In addition, CSG currently has a greenfield facility being constructed at Jiangxi, totally 1.4mn tonnes in capacity when ready (1^{st} phase ready by 2018). In addition, CSG intends to leverage off Hongri Acron's extensive distribution network of 31 trade offices covering 29 provinces in the PRC, as well as its marketing team of over 200 sales people. Comparatively, CSG's current distribution network covers 20 provinces.

- **Low upfront acquisition cost**: Strictly speaking, given CSG's token cash portion of the acquisition, the real acquisition cost is the RMB250mn (~HKD292.5mn) in financial assistance to be given to Hongri Acron. This compares to CSG's last reported cash balance of HKD1.8bn. Hypothetically, CSG will be able to walk away from Hongri Acron should it continue to underperform. Practically, it is possible that Hongri Acron's lenders would require CSG to provide corporate guarantees when Hongri Acron renews or obtains new credit facilities.

- **Not the first distressed acquisition by CSG**: In August 2015, CSG, via its subsidiary Group Sense International Limited, acquired a distressed Magnesium producer based in Xinjiang. The Hongri Acron acquisition is in line with CSG's strategy to be opportunistic about its growth plans, be it organic or inorganic. In addition, given the challenging environment for certain industries in China, inorganic acquisition could be more cost effective.

Acquisition Negatives

- **Deal Structure Unusual**: CSG had previously approached the previous owner of Hongri Acron, Acron PJSC (a listed vertically integrated Russian mineral fertilizer producer) regarding the acquisition of its 50.5% stake in Hongri Acron. However, Acron PJSC was unwilling to accommodate prolonging the completion of the transaction, given that CSG would be required to obtain shareholder approval. To facilitate the transaction, CSG's then executive director / COO and 2^{nd} largest shareholder, Mr George Yang, stepped in and acquired Hongri Acron on 22/07/16, via Mr Yang's unlisted company Best Equity Holdings. Subsequently, on 04/08/16 CSG entered into an acquisition agreement with Best Equity Holdings for the Hongri Acron stake. It is worth noting as well that on 04/08/16, Mr Yang resigned his positions as executive director and COO of CSG. CSG stated that the acquisitions terms between CSG and Best Equity Holdings were substantially the same terms and conditions as those entered with Acron PJSC. There is currently uncertainty as to what would happen if minority shareholders of CSG decide to vote against the acquisition.

- **Hongri Acron is distressed**: Performance has been poor in recent years given the general overcapacity situation facing the China fertilizer industry. Revenue fell from HKD2.14bn in 2014 to HKD466.5mn in 1H2016, while net losses have increased from HKD34.3mn in 2014 to HKD135.9mn in 1H2016. Liquidity is tight, with Hongri Acron facing HKD687.0mn in net current liabilities, while it has <u>negative net assets of HKD87.0mn</u>. Due to working capital limitations, Hongri

Acron brought its production down to 20% during early 2016, though it has since brought it back to 60% currently (with the intent to ramp it back up to 80% by end-2016). We expect that management bandwidth would be needed to turn Hongri Acron around. In mitigation, Hongri Acron had already taken significant impairments over its PPE between 2013 and 1H2016, with CSG indicating that 2013 and 2014 would have been profitable years if these non-cash impairments were excluded.

- **Capital will be needed**: CSG indicated that the RMB250mn in financial assistance to Hongri Acron was driven by the latter's HKD687.0mn in net current liabilities. These liabilities include HKD426.2mn in bank borrowings, which CSG believes will be refinanced. The balance HKD260.7mn in current liabilities will be plugged by the RMB250mn in financial assistance. We expect that CSG will have to provide additional support to Hongri Acron in order for it to have sufficient working capital to ramp up production. For now, Hongri Acron's management indicated that capex needs for 2H2016 is ~RMB3mn. Historically, Hongri Acron spent ~HKD100mn per year on capex over 2013 – 2015. In our view, as we were aware that CSG continues to be in its growth phase[3], CSG would have had to deploy capital anyway if it chose to build greenfield facilities instead.

- **Messy corporate guarantees**: Hongri Acron has existing corporate guarantees provided two independent third party companies ("3rd-party companies"), in exchange for those parties providing similar guarantees to Hongri Acron's debt facilities. Based on CSG's due diligence, these two 3rd-party companies are large and reputable companies in Hongri Acron's city of operations, Linyi City of Jiangxi province. Hongri Acron is liable for guarantees cover RMB180mn notional amount, and these will all expire by July 2017 (the guarantees are renewed annually). It is the intention of CSG to restructure Hongri Acron's debt facilities and to unwind these guarantees if possible. That said, given Hongri Acron's current financial situation, CSG will likely have to be the new corporate guarantor replacing these 3rd-party companies for Hongri Acron's facilities.

- **Relocation risk**: Hongri Acron is currently scheduled to relocate from its existing premises in Linyi City from 2018 onwards, to be completed by 2020. CSG expects that compensation will be provided for the expropriation, and that the fixed assets of Hongri Acron can be redeployed to CSG's other production facilities. CSG believes that given the compensation, as well as the timeframe to schedule the move in phases, the relocation would not meaningfully impact Hongri Acron's performance.

Impact on Credit Profile and Liquidity

- **Revenue to surge, profitability hit to pressure interest coverage**: The consolidation of Hongri Acron, assuming 2015 results (better representing utilization going forward), could have caused CSG's total revenue to jump over 70% y/y. However, the HKD135.9mn in losses generated at Hongri Acron during 1H2016 would have wiped out most of the HKD117.7mn in net profit that CSG generated during the period (though NCI would have taken ~50% of the losses at Hongri Acron). Looking forward, we expect the fertilizer segment gross margins to be negatively affected, as Hongri Acron produces the more commoditized NPK compound fertilizer, while CSG's organic fertilizers and SiMg compound fertilizers offer superior margins. It would take some time for CSG to benefit from savings in SG&A before margins improve. We would monitor the impact on CSG's group EBITDA closely as it could consume the interest coverage covenant headroom. Our estimates of 1H2016 pro-forma consolidated interest coverage is ~3.5x (based on covenant requirements, though certain non-cash adjustments had to be approximated). As such, the acquisition would largely wipe out most of the

[3] OCBC Asia Credit - Century Sunshine Initiation Report 160915

interest coverage covenant headroom. That said, 1H2016 results for Hongri Acron were likely to be usually bad due to low plant utilization of 40% (due to lack of working capital). With production ramped up to 60%, with a target of 70% – 80% by end 2016, Hongri Acron's EBITDA contribution should improve. As a reference, we estimate that Hongri Acron generated negative ~HKD105mn in EBITDA during 1H2016, compared to negative ~HKD26.9mn in 1H2015.

- **Working capital needs likely to strain operating cash flow**: Surprisingly, Hongri Acron was able to generate positive operating cash flow during 2015 and 1H2016. Diving into the details uncovers that these cash flows were generated by Hongri Acron reducing its working capital to generate liquidity. During 1H2016, trade receivables and inventories were reduced by HKD350.1mn while trade payables declined HKD247.9mn. Looking forward, with Hongri Acron ramping up production to usual levels, we expect working capital needs to be a drag on operating cash flow. For now, CSG should be able to fund these via its cash balance.

- **Leverage profile still acceptable post acquisition**: Based on management pro-forma figures, CSG's enlarged group level debt would increase to HKD2411mn (HKD1071mn unsecured, HKD1340mn secured bank borrowings) while net assets would increase to HKD3330mn. This translates into a gross gearing of 72.4%. CSG reported HKD1.80bn in cash while Hongri Acron reported HKD161mn. As such, on a consolidated basis, pro-forma net gearing would be 14%. We estimate pro-forma Consolidated Gross Borrowings to Consolidated Tangible Net Worth to be ~86% (compared to 120% covenant limit). Gross debt-to-EBITDA is likely to worsen from current 2.8x levels due to the expected hit to EBITDA. In aggregate, we believe that CSG currently has the balance sheet to support the Hongri Acron acquisition.

Recommendation: We have reviewed the proposed acquisition of Hongri Acron by CSG. In aggregate, the acquisition is consistent with CSG's growth strategy and would serve to ramp up production capacity as well as market share for CSG's fertilizer segment. That said, we expect some margin deterioration due to product mix shift, as well as the current stressed performance of Hongri Acron. Coupled with expected working capital needs for Hong Acron, there would be a negative impact on CSG's consolidated operating cash flows post the acquisition. With the squeeze on EBITDA, the current covenant headroom for its interest coverage covenant is likely to be consumed. For now, we believe that CSG currently has adequate liquidity to fund these cash needs given its huge cash balance. In aggregate, CSG currently does have the balance sheet to absorb the Hongri Acron acquisition, should it happen, with pro-forma net gearing staying low. That said we believe that CSG would continue to execute its inorganic and organic growth strategy causing its credit profile to continue to slip. **As such, we will reiterate our Neutral Issuer Profile rating on CSG**. Since the acquisition was first announced early August 2016, the CENSUN'18s have sold off due to uncertainties over the transaction, and are now offered at 99c (compared to 102.5c before the announcement). We believe the sell-off to be overdone and continue to believe that the bond offers attractive carry (YTM of 7.8%) for short-dated paper (bond matures June 2018). **As such, we will reiterate our Overweight on the CENSUN'18s**.

Century Sunshine Group Holdings Ltd

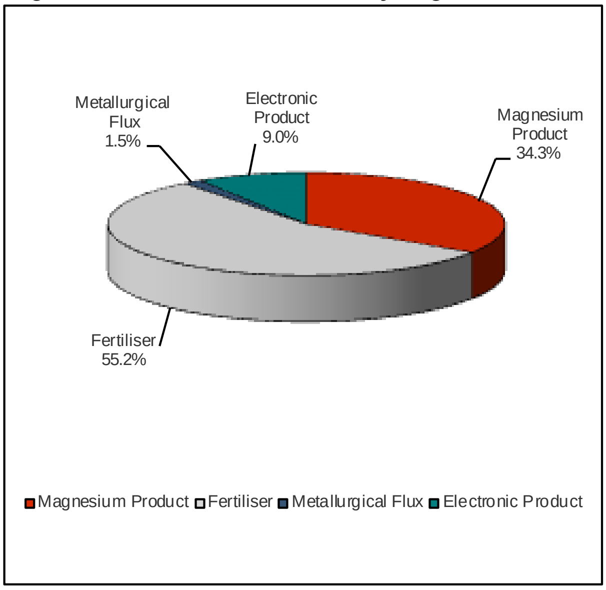
Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	1H2016
Income Statement (HKD'mn)			
Revenue	2,072.5	2,515.6	1,236.1
EBITDA	571.5	629.4	318.6
EBIT	493.5	533.0	257.5
Gross interest expense	46.2	97.0	64.4
Profit Before Tax	467.7	496.9	203.7
Net profit	287.9	303.5	117.7
Balance Sheet (HKD'mn)			
Cash and bank deposits	828.8	1,452.5	1,803.7
Total assets	3,797.0	5,421.7	5,701.8
Gross debt	890.3	1,504.2	1,793.6
Net debt	61.5	51.7	-10.0
Shareholders' equity	2,366.6	3,343.3	3,151.3
Total capitalization	3,256.9	4,847.5	4,945.0
Net capitalization	2,428.2	3,395.0	3,141.3
Cash Flow (HKD'mn)			
Funds from operations (FFO)	365.9	399.9	178.9
CFO	322.9	142.2	397.3
Capex	620.0	217.3	NM
Acquisitions	0.0	200.8	NM
Disposals	0.2	0.4	NM
Dividend	11.7	21.8	NM
Free Cash Flow (FCF)	-297.1	-75.1	NM
FCF adjusted	-308.6	-297.3	NM
Key Ratios			
EBITDA margin (%)	27.6	25.0	25.8
Net margin (%)	13.9	12.1	9.5
Gross debt to EBITDA (x)	1.6	2.4	2.8
Net debt to EBITDA (x)	0.1	0.1	0.0
Gross Debt to Equity (x)	0.38	0.45	0.57
Net Debt to Equity (x)	0.03	0.02	0.00
Gross debt/total capitalisation (%)	27.3	31.0	36.3
Net debt/net capitalisation (%)	2.5	1.5	-0.3
Cash/current borrowings (x)	2.0	4.1	6.1
EBITDA/Total Interest (x)	12.4	6.5	4.9

Source: Company, OCBC estimates

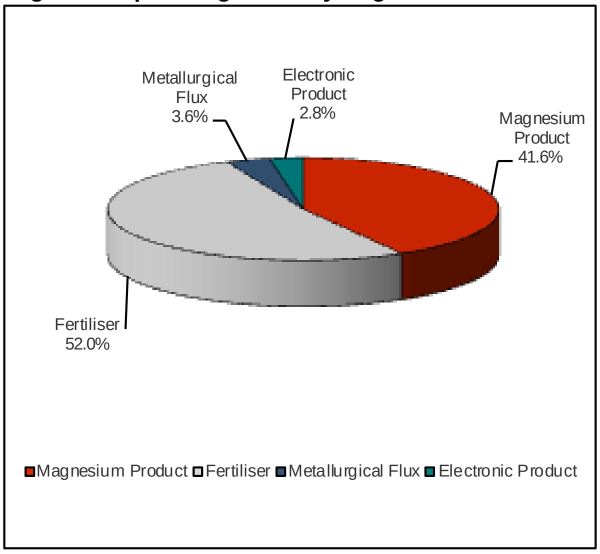
* *FCF Adjusted = FCF - Acquisitions - Dividends + Disposals*

Figure 1: Revenue breakdown by Segment - 1H2016



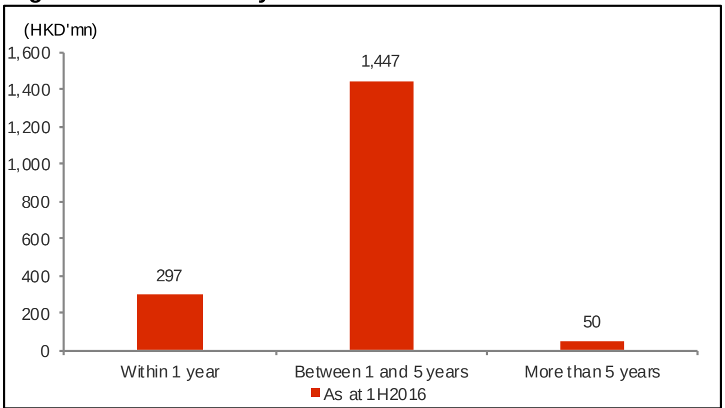
Source: Company

Figure 2: Operating Profit by Segment - 1H2016



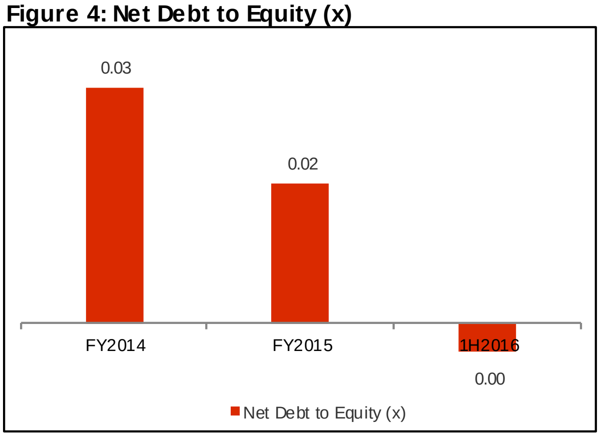
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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