Asia Credit Research

OCBC Bank

Century Sunshine Group: Credit Update

Monday, 17 July 2017

Transitional Period

- Several things are still in motion at CSG. Operationally, CSG is ramping up both its greenfield as well as acquired capacity. The Hongri Acron acquisition was completed on 01/04/17 and will be reflected in CSG's 1H2017 results. Though revenue is expected to surge, margins are likely to worsen due to expected shifts in product mix. Credit profile is also expected to deteriorate, with CSG utilizing more of its balance sheet to fund working capital.
- Corporate structure reorganization is still on-going with CSG intending to inject its magnesium business into its listed subsidiary (GSIL). The recent exchange offer for the CENSUN'18s (and subsequent call to clear the legacy bonds), and extension of the average maturity of debt via the issuance of the CENSUN'20s helps facilitate the reorganization as well as reduce refinancing risk. Finalized terms between CSG and GSIL are not yet known.
- In aggregate, though the injection of the potential injection of the magnesium business into GSIL is a credit negative, the existing financial covenants provide some comfort. **We will reiterate our Neutral Issuer Profile on CSG and are Overweight the new CENSUN'20s**.

A) Recent Developments

Since our last update on Century Sunshine Group Holdings Limited ("CSG")[1], there has been several operational developments, updates on financial performance as well as changes to CSG's capital structure:

1. Preliminary 2016 results were released on 29/03/17, with its annual report released shortly after 18/04/17.
2. On 01/04/17, CSG completed the acquisition of 50.5% equity in Shandong Hongri Chemical Joint Stock Company Ltd ("Hongri Acron"), and hence will be consolidated into CSG's financials subsequently. The transaction was first announced in August 2016[2].
3. On 18/04/17, CSG announced that it was entering into an MOU with Group Sense (International) Limited ("GSIL"), a 51.5%-owned listed subsidiary of CSG. The intention is for CSG to inject its magnesium related businesses into GSIL, in order to facilitate better delineation between the two segments.
4. On 09/05/17, an exchange offer and consent solicitation exercise was launched, to 1) offer to exchange the CENSUN'18 for the new CENSUN'20 (with adjustments to guarantors to facilitate reorganization and tweaking of incurrence covenants); and 2) seek consent to amend call terms on the CENSUN'18s. Subsequently, SGD101.75mn of the new CENSUN'20s were issued (including SGD38.25mn bonds exchanged). The call date on the CENSUN'18s was also amended, with the company calling the SGD86.75mn balance on 30/06/17.
5. On 19/06/17, voluntary select 1Q2017 financial results were released, providing some operational updates on CSG.

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[1] Singapore 2017 Credit Outlook 060117
[2] OCBC Asian Credit Daily - 08 August 2016

B) 2016 Performance Review

- **FX and ASP Pressure Impacted Sales**: For the fiscal year ending December 2016, total revenue grew 2.9% y/y to HKD2.59bn, compared to the 21.4% y/y revenue growth seen in the previous year. Management had indicated that the slump in RMB (CSG's operating currency) versus HKD (CSG's reporting currency) had a negative impact on revenue growth reported. That said, though sales volume exhibited growth for both the fertilizer and magnesium segments, average selling price ("ASP") saw some pressure. Current revenue split across segments is 54.0% from Fertilizer, 35.2% from Magnesium and 10.8% from Others (such as metallurgical flux and GSIL's legacy electronics business). It is worth noting that revenue share from Fertilizer declined from 60.6% in 2015, with Magnesium increasing from 30.2%. Despite softness in revenue growth, CSG managed to sustain gross margins at 29.3% (2015: 31.2%), with the margin compression largely driven by intentional shifts in product mix at the magnesium segment.

- **Fertilizer Segment Outperformed Industry**: Segment revenue declined 8.2% y/y to HKD1.40bn. Though volume sold increased 4.6% y/y to 692,197 tonnes, ASP fell 12.2% y/y to HKD2,021 per tonne. We consider CSG's performance to be strong, as market leader Sinofert reported 30.1% y/y decline in sales volume and 38.6% y/y decline in sales value for its compound fertilizers in 2016. CSG had indicated that ASP fell in part due to the declines in global commodity prices (with CSG passing the cost savings to clients). Segment gross margin remains robust at 28.4% (2015: 27.9%) with CSG's market leadership in the more niche organic fertilizer and silicon magnesium compound fertilizer sustaining margins. This helped to mitigate competitive pressure seen at compound fertilizers. Looking forward, the fertilizer segment is expected to see strong revenue growth due to the ramp up in capacity. CSG has ramped up its existing Jiangsu facility to an annual capacity of 850,000 tonnes during 2016, expects its green field Jiangxi plant to commence initial operations in 3Q2017 (phase one: 550,000 tonnes of an eventual total capacity of 1,400,000), and expects annual capacity at its recently acquired Hongri Acron to reach 700,000 tonnes in 2017. It is likely that there would be some gross margin pressure when the Hongri Acron capacity ramps up, with management still tweaking operations and product mix.

- **Product Mix Pressures Magnesium Margin**: Magnesium sales surged 19.8% y/y to HKD911.0mn, largely driven by the 50.6% y/y increase in sales volume to 36,201 tonnes (2015: 24,031 tonnes). However, ASP fell sharply by 20.8% y/y to HKD24,388 per tonne (2015: HKD30,806). This was largely driven by shifts in product mix. The more lucrative rare earth magnesium alloy production was largely capped by CSG's original Jilin facility with 25,000 tonnes annual capacity (an additional 50,000 tonnes capacity was recently completed, with the company commencing trial operations on the production line). The additional volume sold was largely from its Xinjiang facility (held under listed subsidiary GSIL), which was acquired in 2015 and had an annual magnesium capacity of 15,000 tonnes. Production at Xinjiang only resumed in 1Q2016, with CSG focusing on ramping up basic magnesium products first. Major enhancement projects were rolled out in November 2016 at the Xinjiang facility, which allowed CSG to ramp production up to ~70% of planned production capacity. As a result, the volume of basic magnesium products surged 98.1% y/y, but at the expense of segment margins. Looking forward, segment sales are likely to be driven by the ramp up in production capacity by the group. The Jilin facility now has 75,000 tonnes in annual capacity while the Xinjiang facility has 15,000 tonnes (and is approved to build up to 100,000 tonnes). In the short term, we expect there to be margin pressure, as the ramp up in production would likely focus first on the more basic magnesium products rather than the lucrative rare-earth magnesium alloys.

- **Earnings and Cash flow**: With revenue flattish, and gross margin tighter, CSG saw gross profit falling 3.3% y/y to HKD759.9mn. SG&A expenses were flat at HKD253mn, with declines in selling / marketing expenses offset by increases in administrative costs (due to the recent acquisitions). In aggregate, operating profit fell 5.1% y/y to HKD574.5mn, largely due to the decrease in gross profits. Financing cost jumped 34.5% y/y to HKD117.6mn due to increase in borrowings. As such, CSG generated HKD313.1mn in net profits, down 13.8% y/y. We estimated that EBITDA was HKD636.8mn (flattish compared to 2015's HKD629.4mn). Cash flow generation was strong, with operating cash flow (including interest service) jumping to HKD428.6mn (2015: HKD84.3mn) as working capital needs were less of a burden on cash compared to 2015. However, capex jumped as well to HKD479.0mn (2015: HKD217.3mn) due to CSG's various expansion needs (at Jilin, Jiangxi and Jiangsu). As such, free cash flow remained negative at HKD50.4mn (though improving from negative HKD133mn the previous year). With working capital needs likely to ramp up due to the rolling in of new capacity during this year and beyond, as well as the HKD200mn – HKD300mn in annual capex over the next few years, it is possible that free cash flow could remain negative in the near term. CSG had also made HKD233.8mn worth of advances to Hongri Acron, before the acquisition was completed in April 2017 (this was part of the transaction considerations). In addition, during 2016, CSG cleaned up its organization ownership structure, buying out minority shareholders in various parts of the group spending HKD275.3mn in increasing its stake in non-wholly owned subsidiaries. The cash gap was funded by HKD146.4mn in additional borrowings as well as drawing down HKD418.5mn from its cash balance.

- **Credit Profile and Liquidity**: Due to the increase in borrowings and the drawdown on cash balance, CSG has turned from a net cash company (as of end-2015) to a net gearing of 21%, though it remains low on absolute basis. Net Debt / EBITDA was strong as well at 1.0x. Interest coverage (including capitalized interest) declined to 5.0x (2015: 6.5x) due to higher financing cost. HKD320.7mn in current borrowings could be met by CSG's cash balance of HKD901.2mn. Looking forward, as CSG continues to fund its growth plans and allocate working capital to its new capacity, we expect CSG's leverage profile to steadily worsen as more capital is being deployed. This is mitigated by the 3.0x interest coverage covenant and 1.5x gross borrowings to NTA incurrence covenant on the bonds (gross borrowings to NTA at 0.61 as of end-2016). It should be noted though that with the Hongri Acron acquisition (completed in April 2017), there could be an impact on CSG's credit profile as well as negative impact on earnings. Hongri Acron remains loss making, and its results will be consolidated into CSG's results from 1H2017 onwards. That said, we have previously opined (see Century Sunshine Credit Update 29/09/16) that CSG's balance sheet should be able to absorb the acquisition.

C) 1Q2017 Hints and Future Trends:

On 19/06/17, CSG voluntarily disclosed some 1Q2017 operational figures, which reflect a continuation of 2016 trends. Total revenue from the fertilizer and magnesium segments was HKD443.6mn, up 4.9% y/y. Segment contribution shift continued, with growth in the magnesium segment revenue offsetting weakness at the fertilizer segment. Do note that the numbers exclude the impact of Hongri Acron as the transaction had not closed as of end-1Q2017.

The fertilizer segment continued to face industry headwinds, with volume sold modest (-1.4% y/y to 138,971 tonnes) while ASP dipped 7.8% lower y/y to HKD1,958 per tonne. The softer revenue generated drove segment gross profits lower 11.1% y/y to

HKD70.4mn. On the bright side, segment gross margins were largely sustained at 25.9% (1Q2016: 26.5%). ASP was also higher q/q, which management stated could be a sign that ASP decline for fertilizer has bottomed out. In fact, fertilizer segment gross margins were wider than magnesium gross margins for the quarter.

For the magnesium segment, the revenue surge was even higher at +38.5% y/y compared to 2016, with HKD171.9mn generated, driven by 70.0% y/y increase in volume sold to 8,639 tonnes. However, this was again driven by the ramp up in production at the Xinjiang facility, which consists of mainly basic magnesium products (intentional as CSG is seeking to streamline the product line first with simpler products). As a result, ASP took a beating, declining 18.5% y/y to HKD19,896 per tonne. This drove magnesium segment gross margins to just 21.3% (-7.9ppt), with segment gross profit only up 1.0% to HKD36.6mn despite the surge in volume sold. It is worth noting that CSG's high-end product, rare earth magnesium alloys, managed to sustain its high gross profit margin of 40.4% (1Q2016: 42.5%) with sales volume at 1,890 tonnes (22% of segment volume sold). Looking forward, as CSG shifts its product mix away from basic magnesium products to rare-earth magnesium alloys, segment revenue and gross profit should improve.

As a result of gross margin compression seen at both segments, the gross margin for the group fell 2.9ppt to 25.8% for the quarter. With Hongri Acron being consolidated from 2Q2017 onwards, we expect 1H2017 performance to be distinctly weaker profitability wise despite the expected surge in revenue (from both the Xinjiang plant driving magnesium revenue, and from Hongri Acron driving fertilizer revenue).

With the production ramp up and product shifts being the main driver of margin compression, as well as the capex needs for the expansions, it is worth considering management's guidance for CSG's future capacity. Management had shared 2016 capacity and have indicated their targets for 2017 utilization below:

	2016 Capacity	2016 Utilization	2017E Capacity	2017E Utilization
Fertilizer	850k tonnes	689k tonnes	2220K tonnes	1455k tonnes
Magnesium	40k tonnes	28.6k tonnes	95k tonnes	50k tonnes

Source: Company

Fertilizer: The first phase of the Jiangxi facility (550,000 tonnes of 1.4mn) was guided to be ready in 3Q2017, ahead of the original 2018 schedule (the balance 850,000 tonnes remained scheduled for 2019). In addition, Hongri Acron's 820,000 tonnes annual capacity will be added from April 2017 onwards. This brings total fertilizer capacity to 2,220,000 tonnes by end 2017, though management expects only to produce 1,455,000 tonnes given the different times that the production facilities go on-stream.

Magnesium: As mentioned earlier, CSG had ramped up production at the Jilin magnesium plant to 75,000 tonnes, while the Xinjiang facility (held by GSIL) will start construction of an additional 30,000 tonnes in 2017, complementing the existing 15,000 tonnes. As such, management expects to reach roughly 95,000 tonnes by year end. It is worth noting that based on 1Q2017 numbers, ~34,500 tonnes have been sold on an annualized basis.

As mentioned earlier, management had guided between HKD200mn – HKD300mn in annual capex over the next few years. 2016 had seen CSG keeping the negative free cash flow at a minimum, though we would not be surprised if CSG's cash balance gets depleted to fund working capital needs. It is worth noting that management stated that they are not married to the timeline for the expansion of capacity if demand does not support it, preferring to prioritize the upgrading of existing facilities to produce higher-margin products. In our view, operationally 2017 would be a transition year, with CSG integrating acquired capacity, expanding existing facilities and building on-stream greenfield ones. As such, there will be some execution risk which we will monitor closely, beyond the intended margin deterioration from shifting product mix.

D) Considering the Recent Corporate Actions

Background: When CSG first came to market and issued the CENSUN'18s, management had already discussed their then recent acquisition of GSIL[3]. As a recap, CSG's management mentioned then that over the long term, they may restructure the magnesium business into GSIL, which would allow CSG to develop and differentiate the two business segments under two listing platforms. As per Hong Kong Stock Exchange Rules 14.92 and 14.93, as the transaction to acquire GSIL was treated as a reverse takeover, there were restrictions on CSG's ability to dispose GSIL's assets within the next 24 months after the change in control (as of the completion date 26/02/15). Since then, management had followed this path, utilizing GSIL to acquire the Xinjiang magnesium facility in December 2015. Given that the second year anniversary to the acquisition of GSIL had passed, CENSUN now has the flexibility to restructure GSIL as it sees fit. It is in this context that the recent corporate actions were taken.

Details: When the CENSUN'18s were issued, given CSG's long-term intent for GSIL, the CENSUN'18s were structured such that should CSG inject assets into GSIL, GSIL would be made into a guarantor to the CENSUN'18s (to be clear, GSIL was not a guarantor to the CENSUN'18s at the point of issuance). At present, management had decided to proceed with the corporate reorganization, having announced a memorandum of understanding[4] mid-April 2017 regarding a possible very substantial disposal by CENSUN of its magnesium related entities into GSIL. The terms of the possible transaction, including consideration and method of payment, have not been decided. That said, the announcement also indicated that should the consideration involve shares of GSIL, the issue or conversion price per share of GSIL will not exceed HKD0.40 per share (which indicates that GSIL's equity was being deliberated as a possible consideration, aside from cash). CSG's management had indicated that the existing terms of the CENSUN'18s would mean that GSIL would become a guarantor to the bonds, adding complexity to the reorganization (as GSIL is only 52% owned, it has minority shareholders), which was already a Connected Transaction and a Very Substantial Disposal / Acquisition by CSG and GSIL respectively according to HKSE definitions.

Intent: The recent corporate actions by CSG actually had three purposes: 1) to refinance the CENSUN'18s ahead of time 2) to change the terms on its bonds to facilitate the possible transaction with GSIL, as well as 3) to loosen its financial covenants slightly to create more covenant headroom. As such a recent consent solicitation exercise and bond exchange was conducted and completed in May/June 2017. The outcome of the exercise was as follows:

- The consent solicitation exercise was mainly to amend the call date and notice period required. This was to facilitate the potential clean-up of the outstanding CENSUN'18 bonds that did not participate in the bond exchange. **The consent solicitation ultimately passed, and CSG called the outstanding SGD86.75mn in CENSUN'18s on 30/06/17**.

- The bond exchange was to entice existing holders of the CENSUN'18s to roll their positions over into the new CENSUN'20s. Simultaneously, new funds would be raised as well. It should be noted that the terms of the new

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

[4] HKSE – 509, 601 Joint Announcement – Inside Information: Memorandum of Understanding (18/04/17)

CENSUN’20s differ from the previous CENSUN’18s in that 1) the incurrence covenant of maximum gross borrowings to gross tangible net worth was loosened to 1.5x (from 1.2x). 2) adjustments were also made to bond guarantors to facilitate the injection of magnesium segment related entities into GSIL. Ultimately, SGD38.25mn worth of the SGD125mn CENSUN’18s tendered their bonds for the new CENSUN’20s. Some new funds were raised as well, bringing the total issue size of the new CENSUN’20s to SGD101.75mn.

Our Takeaways: In aggregate, we consider the potential removal of CSG’s magnesium segment related entities via its divestment from CSG into GSIL to be a **credit negative**. Should the divestment occur, though CSG would continue to consolidate the results from the magnesium segment as GSIL is a majority owned subsidiary, the cash flows generated from the magnesium segment would now be held at the GSIL level, and can only be sent to the parent (CSG) via dividends. In addition, in the event that CSG falls into distress, noteholders will not have direct claim over the assets held by GSIL, with only the 52% shareholding in GSIL as an asset to claim against. Instead, noteholders have to rely even more on the financial covenants that CSG has to limit CSG’s leverage. Specifically, CSG has:

- Incurrence covenant preventing CSG from raising debt beyond 1.5x gross borrowings to gross tangible net worth.

- Maintenance covenant requiring CSG to have 1) consolidated tangible net worth higher than HKD1.8bn; 2) gross borrowings to gross tangible net worth no higher than 2x; and 3) EBITDA to interest expense no lower than 3.0x.

Currently, CSG does have some covenant headroom, with gross borrowings to gross tangible net worth at 0.61x (as at end-2016) while reported EBITDA / Interest Expense was 5.9x (as of end-2016, based on EBITDA adjustments as required for the covenant). Looking forward, we expect some of these covenant headroom to be consumed due to the Hongri Acron acquisition (negative EBITDA impact as Hongri Acron was a distressed acquisition), as well as the use of cash for working capital needs (due to the ramp up in production). For now, we are comfortable given the covenant headroom that CSG has, as well as the low absolute amount of leverage with net gearing at 21%. That said, we remain cautious regarding how consolidated numbers would look for 1H2017 when Hongri Acron is integrated. As a reference, our previous pro-forma gross borrowings to tangible net worth was ~86% (based on 1H2016 numbers, the last time financials for Hongri Acron was disclosed).

E) Conclusion and Recommendation

We have considered CSG’s performance for 2016 as well as for 1Q2017, and concluded that near-term performance is likely to be dominated by CSG’s shift in product mix (due to the ramp up of production facilities) squeezing margins, even though revenue growth remains robust. We have also reviewed the recent corporate actions taken and though we consider the potential injection of the magnesium segment into partially-owned GSIL to be a credit negative, the financial covenants in place help to curtail deterioration to CSG’s credit profile. The covenants also help provide some solace given the expected deterioration to CSG’s financials post the consolidation of Hongri Acron from 1H2017 onwards. For now, **we will retain our Neutral Issuer Profile on CSG**, and will monitor 1H2017 results (expected mid-September) closely. When considering the new CENSUN’20s, when the CENSUN’18s were first priced, it was at a spread of 3Y SDSW + 560bps. Today, the new CENSUN’20s are trading at a spread of +570bps above 3Y SDSW. The old CENSUN’18s have traded below 5.8% YTM at its peak, and though we acknowledge that CSG has a few negative catalysts in the horizon, its overall performance has been as expected, which could drive spreads below 500bps, for a YTM of 6.4% (from the currently 7.1%). As such, we are **Overweight the CENSUN’20s**.

Century Sunshine Group Holdings Ltd

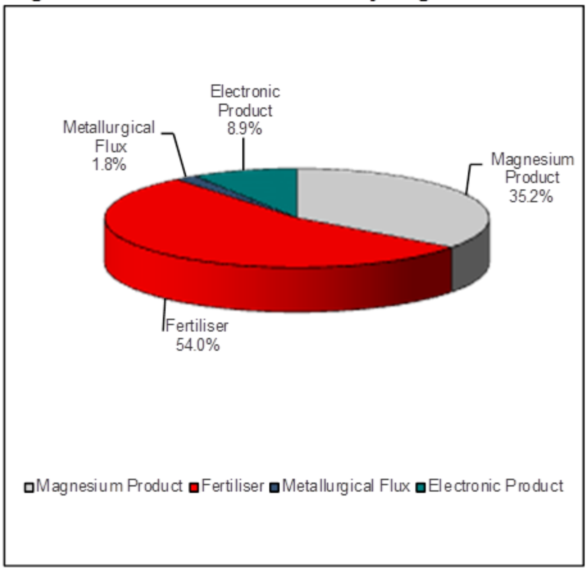
Table 1: Summary Financials

Year End 31st Dec	FY2014	FY2015	FY2016
Income Statement (HKD'mn)			
Revenue	2,072.5	2,515.6	2,589.2
EBITDA	571.5	629.4	636.8
EBIT	493.5	533.0	506.6
Gross interest expense	46.2	97.0	126.6
Profit Before Tax	467.7	496.9	456.9
Net profit	287.9	303.5	313.1
Balance Sheet (HKD'mn)			
Cash and bank deposits	828.8	1,452.5	901.2
Total assets	3,797.0	5,421.7	5,246.5
Gross debt	890.3	1,504.2	1,540.6
Net debt	61.5	51.7	639.4
Shareholders' equity	2,366.6	3,343.3	3,054.5
Total capitalization	3,256.9	4,847.5	4,595.1
Net capitalization	2,428.2	3,395.0	3,693.9
Cash Flow (HKD'mn)			
Funds from operations (FFO)	365.9	399.9	443.2
* CFO	295.3	84.3	428.6
Capex	620.0	217.3	479.0
Acquisitions	0.0	312.4	85.5
Disposals	0.2	0.4	70.1
Dividend	11.7	21.8	59.8
Free Cash Flow (FCF)	-324.7	-133.0	-50.4
* FCF adjusted	-336.2	-466.7	-125.5
Key Ratios			
EBITDA margin (%)	27.6	25.0	24.6
Net margin (%)	13.9	12.1	12.1
Gross debt to EBITDA (x)	1.6	2.4	2.4
Net debt to EBITDA (x)	0.1	0.1	1.0
Gross Debt to Equity (x)	0.38	0.45	0.50
Net Debt to Equity (x)	0.03	0.02	0.21
Gross debt/total capitalisation (%)	27.3	31.0	33.5
Net debt/net capitalisation (%)	2.5	1.5	17.3
Cash/current borrowings (x)	2.0	4.1	2.8
EBITDA/Total Interest (x)	12.4	6.5	5.0

Source: Company, OCBC estimates

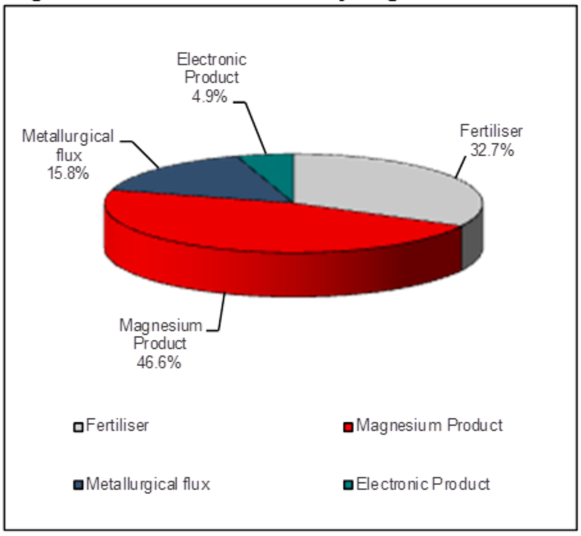
**FCF Adjusted = FCF - Acquisitions - Dividends + Disposals | *CFO after deducting interest expense*

Figure 1: Revenue breakdown by Segment - FY2016



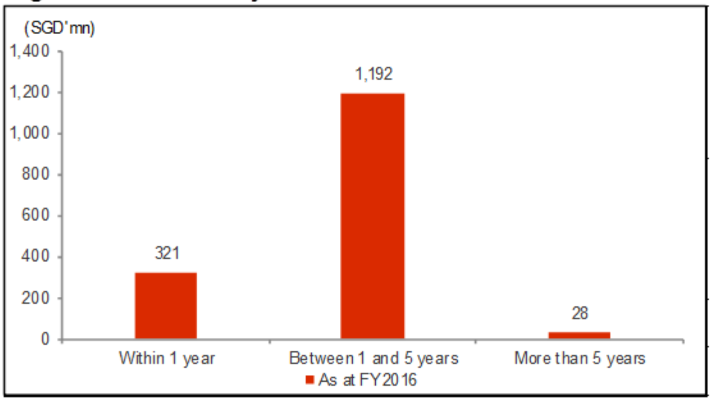
Source: Company

Figure 2: Asset breakdown by Segment - FY2016



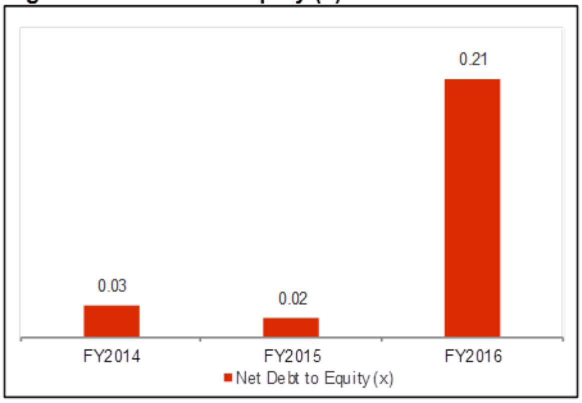
Source: Company

Figure 3: Debt Maturity Profile



Source: Company

Figure 4: Net Debt to Equity (x)



Source: Company, OCBC estimates

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