Issuer Profile:
Negative (6)

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Ticker:
CENSUN

Ezien Hoo, CFA
+65 6722 2215
EzienHoo@ocbc.com

Century Sunshine Group Holdings Limited ("CENSUN")

Recommendation

- **For 1H2019, CENSUN reported overall revenue that was down 4.2% y/y to HKD2.12bn though overall gross profit was only down by 2.5% y/y to HKD535.1mn as gross margins on its higher value-added sub-segments within Fertiliser and Magnesium held up. Interest coverage at CENSUN remains commendable at 5.9x although its market implied net gearing was high at 1.7x.**
- **CENSUN has announced that it will gradually scale down and cease production of its Shandong Hongri facility in Linyi City. This is in conjunction with the requirements of the Shandong Provincial Government to relocate industrial facilities from the urban city area to industrial parks. Instead of a new plant, production will be taken up by existing facilities in Jiangxi and Jiangsu instead while the underlying land where the Shandong facility now sits is intended to be converted into commercial use and sold. We see the possible sale as an upside case (rather than base case) in light of the uncertain timing, uncertain quantum of net proceeds and approvals required.**
- **The company faces a significant maturity wall in the form of HKD1.1bn in mostly bank debt coming due in the 12 months from 30 June 2019 to 30 June 2020 while its sole SGD-denominated bond, the CENSUN 7.0%' 20s, is due soon after. We expect the company to seek a partial refinancing/roll-over of its HKD1.1bn (largely bank debt) and to return to market to seek a replacement bond for the CENSUN 7.0% '20s. Should the company be forced to fully pay down HKD1.1bn in bank debt instead, its weakened liquidity position could likely trigger a downgrade of the company.**
- **For now we are maintaining CENSUN's issuer profile at Negative (6) and are Underweight the sole SGD-bond. We may consider an issuer profile upgrade only when (1) the maturity wall is resolved, in a manner where other capital source providers also step in for refinancing with a termed out structure and/or (2) monetization of Shandong Hongri land completes by end-1H2020 with net proceeds used for debt obligations rather than growth capex.**

Relative Value:

Bond	Maturity / Call date	Market Implied Net gearing	Ask YTM	Spread
CENSUN 7.0% '20s	03/07/2020	1.7x	21.0%	1,960bps
ASPSP 5.3% '20s	01/04/2020	3.2x	7.41%	595bps
ASPSP 5.25% '20s	28/08/2020	3.2x	7.20%	592bps

Indicative prices as at 11 November 2019 Source: Bloomberg
Net gearing based on debt and cash of latest available quarter

Background

- Listed on the HKSE, Century Sunshine Group Holdings Limited ("CENSUN") with a market cap of HKD984.9mn as at 11 November 2019, has two main business segments: magnesium products and fertilisers. The magnesium business is held via CENSUN's 72.4% indirect stake in Rare Earth Magnesium Technology Group Holdings Limited ("REMT"), a separate HKSE-listed company with a market cap of HKD2.0bn as at 11 November 2019.
- CENSUN is ~35%-owned by the founder/Chairman while IFC has a ~17% interest in the company via a 5% direct stake and 12%-stake held as collateral for a loan. The remaining shareholding interest is dispersed.

Key Considerations

- **Decline in top line led by Magnesium segment in 1H2019:** For 1H2019, CENSUN reported overall revenue that was down 4.2% y/y to HKD2.12bn though overall gross profit was only down by 2.5% y/y to HKD535.1mn. By key segments, the main drag to top line was its magnesium business held under REMT where revenue had declined 8.7% y/y to HKD726.2mn mainly due to the fall in sales volume of magnesium products by 11.1% y/y which was insufficiently offset by a 2.9% y/y increase in average selling price. While the company explained that this was due to adjustments away from low-margin basic magnesium products. Magnesium products in China are used as inputs, mainly for transportation products, followed by electronic communication products. We note that 1H2019 passenger car sales were weak in China (albeit with y/y fall narrowing since June 2019) while electronic exports were also reportedly weak. Despite the fall in Magnesium top line, gross profit held up at HKD206.3mn (1H2018: HKD202.7mn), indicating that REMT's focus on rare earth magnesium alloy had buffered the decline.

- **Watching for margin compression in Fertiliser over longer term:** The Overall Fertiliser segment also saw revenue decline, though narrower at 1.6% y/y, led by its General Fertiliser sub-segment which was affected by a gradual decline in production and sales at its Shandong Hongri facility to Jiangxi and Jiangsu. Gross profit margin though held up for the Overall Fertiliser segment at 23%, this was despite a fall in margins for its General Fertiliser sub-segment as Functional Fertilisers and Ecological Fertilisers (ie: organic) continued to drive Feriliser gross profit at CENSUN. That being said, we continue to expect General Fertiliser gross margin to fall. CENSUN's gross profit margin for General Fertiliser was 17.4% for 1H2018 and 13.8% in 1H2017, which is on the high side in our view versus peers. It is hard for us to take for granted that gross profit margin on CENSUN's Functional Fertilisers and Ecological Fertilisers would continue growing and thereby offsetting our expected fall in General Fertiliser gross profit margin. We understand that for both these higher value sub-segments, gross profit margin exceeds 30% whilst competitors are trying to move up the value-chain as well which may lead to longer term margin compression. For now, we take comfort that CENSUN had managed to get its serpentine mine license extended to 2027 (originally was to expire in October 2020), with serpentine being a key input into its Functional Fertiliser business.

- **Relocation of Shandong Hongri production capacity:** CENSUN owns an effective ~70%-stake in Shandong Hongri Chemical Joint Stock Co Ltd ("Shandong Hongri"), bought in two tranches in 2017. The first tranche of a 50.5% controlling stake was bought from an entity that was partly owned by one of CENSUN's then directors at a consideration of USD1 in a distressed acquisition. In July 2019, CENSUN announced that it will gradually scale down and cease the production of its Shandong Hongri facility in Linyi City. This is in conjunction with the requirements of the Shandong Provincial Government to relocate industrial facilities from the urban city area to industrial parks. The production facility has an annual capacity to produce ~820,000 tons though we note actual utilisation in 2018 was ~500,000 tonnes of compound fertiliser. The company intends to shift production to its existing Jiangxi and Jiangsu plants rather than build a new replacement plant in Shandong Province given that the current unutilised capacity at both its Jiangxi and Jiangsu facilities is sufficient to replace the actual production volumes of Shandong Hongri. As such, we expect the shift of production itself to be capex-neutral while we do not expect operations to be significantly affected as CENSUN intends to continue operating the Shandong Hongri sales distribution network with sale orders put to production at the other two production facilities.

- **……with underlying land to be sold:** Subject to approval from authorities, the company intends to sell the underlying land where the Shandong Hongri production facility sits for commercial use (ie: industrial to commercial land conversion). The value of the land is expected to be more than RMB2.6bn (valuation as at 30 June 2019) post conversion into commercial use although the eventual net proceeds to CENSUN is yet to be determined. As the buyer(s) would be required to pay a land conversion premium, this in our view will affect net proceeds to CENSUN. Should this occur, one-off gain is likely to be significant as total land use rights on CENSUN's balance sheet only amount to HKD298mn as at 30 June 2019. In our view, this is an upside case given the uncertain timing, uncertain quantum of net proceeds and regulatory approvals required.

- **High market implied net gearing:** As at 30 June 2019, CENSUN's gross gearing was 0.50x, slightly lower than end-2018, though, adjusted net gearing, taking only unpledged cash was 0.40x, increasing from 0.38x in end-2018. While the company's book value gearing numbers look manageable, it continues to be incongruent with market implied levels. As at 11 November 2019, we find CENSUN's market cap at HKD984.9mn, representing 24% of its book value of equity and indicating a net debt-to-market value of equity of 1.7x. Whilst REMT has a market cap of HKD2.0bn, implying that CENSUN's indirect 72.4%-stake in REMT is worth HKD1.4bn and exceeding its own market cap. That being said, we are not putting too much liquidity weightage on this stake given the lack of an active market in the REMT equity (despite the listed status). Net-net, the main source of liquidity from equity in our view is dependent on the major shareholders, rather than public investors. This is compounded in our view by the lack of dividend payment to shareholders since 2017.

- **Capex and working capital dragged 1H2019 cash flow:** While CENSUN was able to generate healthy levels of EBITDA at HKD483.3mn in 1H2019 (1H2018: HKD478.9mn), reported net cash generated from operating activities was only HKD191.7mn (1H2019: HKD325.4mn). Based on our estimation, CENSUN consumed HKD222.9mn in working capital during 1H2019. Mainly, we saw CENSUN's trade and bills payable and contract liabilities (eg: sales receipt in advance) lower versus end-2018. Despite the lower operating cash flow, CENSUN spent HKD273.8mn in net investing outflow during the period, significantly higher than the capex commitment of HKD179.2mn in end-2018. We think the cash gap was predominantly funded by drawing down existing cash.

- **Facing a large maturity wall:** CENSUN faces HKD1.1bn in debt coming due in the 12 months between 30 June 2019 and 30 June 2020, representing 51% of gross debt. The SGD-denominated bond, the CENSUN 7% '20s, with an outstanding amount of SGD101.75mn (~HKD585.4mn) which comes due in July 2019 adds to this HKD1.1bn. Cash had continued to dwindle at CENSUN, with unpledged cash of only HKD436.6mn as at 30 June 2019 (end-2018: HKD568.7mn), representing unpledged cash-to-short term debt of 0.4x and only 0.26x if we include the SGD bond due. We understand from CENSUN that committed unutilised bank facilities as at 30 June 2019 stood at ~CNY196mn (~HKD219mn). Based on our preliminary analysis of short term uses and sources of funds, we think CENSUN is facing a gap of HKD1.2bn (a gap of HKD844mn if it defers all capex), which means that rather than fully paying down its obligations, a sizeable amount of upcoming obligations would need to be refinanced/rolled-over.

Preliminary analysis of short term uses and sources of funds

Date	Uses of Funds	HKD'mn	Date	Sources of Funds	HKD'mn
12 months forward from 30 Jun 2019	Debt at REMT level	135.5	As at end Jun 2019	Cash on balance sheet	533.1
	CENSUN bank debt	937.0		(-) Pledged cash	(96.6)
				Undrawn committed credit facilities	219.0
July 2020	CENSUN SGD bond	585.4	2H2019	EBITDA minus working capital as proxy to CFO before tax and interest	264.0
2H2019	OCBC assumed maintenance capex	75.0	1H2020	EBITDA minus working capital as proxy to CFO before tax and interest	264.0
1H2020	OCBC assumed maintenance capex	75.0	2H2019	(-) Interest expense and taxes	(185.0)
2H2019 and 1H2020	Assumed capex projection for Jiangxi Phase II	220.0	1H2020	(-) Interest expense and taxes	(185.0)

Total	2,027.9	Total	813.5
Note: (1) We assume HKD150mn p.a in maintenance capex based on company's depreciation and amortization for 1H2017 (where Shandong Hongri was only included since April 2017). As Shandong Hongri production facilities is scaled down, we assume that maintenance capex would no longer needed on this facility (2) Capex projection for Jiangxi Phase II is for growth capex and we understand this is more discretionary in nature and can be gradually phased in		Note: (1) We have taken EBITDA for 1H2019 of HKD483mn as 2H2019 and 1H2020 EBITDA (2) CENSUN's working capital fluctuates period to period. Conservatively, we are assuming working capital needs being 10% of revenue and EBITDA margin of 22% (3) We take the 1H2019 interest expense and taxes for 2H2019 and 1H2020	

Source: Company, interim financial reports, OCBC Credit Research analysis

- **Asset coverage without factoring in upside from Shandong Hongri land:** As at 30 June 2019, property, plant and equipment ("PPE") was the largest component of total assets, making up 54% of total asset values. In end-2018, 1/3 of PPE though comprised construction-in-progress which in our view is of little value until completion. PPE breakdown as at 30 June 2019 was not provided though we use 1/3 of PPE as assumption of construction-in-progress assets. Removing this, we estimate that CENSUN has HKD2.9bn of non-cash assets that lenders are open to accepting as security, namely, PPE (excluding construction-in-progress) and land use rights. As at 30 June 2019, HKD757.8mn of such non-cash assets has been pledged, leaving ~HKD2.2bn. We further adjust downwards this number as Shandong Hongri's plant is going to cease production. Simplistically, we take the difference in PPE as at end-2016 and 30 June 2017 given that Shandong Hongri was first consolidated in April 2017 as adjustment figure and arrive at HKD1.4bn in remaining unpledged PPE (excluding construction-in-progress) and land use rights. Other assets that may still generate liquidity if sold and/or used as security include trade and bills receivable, mining rights and inventory. These collectively have a book value of HKD1.4bn as at 30 June 2019. Net-net, we think monetisable non-cash assets is capped at HKD2.8bn against HKD2.1bn of gross debt as at 30 June 2019. This though does not factor in the potential upside from the possible land sale at Shandong Hongri.

- **Requires lenders to be supportive of a refinancing/roll-over rather than full debt pay down:** Common across true high yield issuers, the company would likely need to seek refinancing on its debt coming due rather than fully pare down debt due. The SGD-bond amounting to ~HKD585mn only matures in July 2020, after the HKD1.1bn of debt comes due (eg: likely mainly bank funded). We estimate that bank sources now make up about half of CENSUN's gross debt. A full pay down of the HKD1.1bn of debt would decrease the company's leverage levels though would likely mean the company exhausting its immediate liquidity sources (existing cash balance, unutilised committed banking facilities) and near-term operating cash flow to repay bank lenders. Aside from the HKD1.1bn in short-term debt due and the SGD-bond, there is another ~HKD445mn of debt coming due after 30 June 2020, mainly non-bank debt. Apart from exacerbating near-term liquidity, the SGD bondholders would be proportionately the single largest debt provider to the company. A significant reliance on the high yield bond market, without proportionate assumption of risk by other capital providers justifies a downgrade in our view.

- **Still manageable interest coverage ratio:** In view of CENSUN's manageable interest coverage ratio, we think a likelier scenario will be the partial refinancing of bank debt (rather than full payment). In 1H2019, EBITDA (based on our calculation which does not take into account other income and other expenses) was HKD483.3mn (up 0.9% y/y), while finance costs reduced by 10.2% y/y to HKD82.4mn despite average gross debt staying relatively constant y/y. Per company, the decline was due to lower quantum of financing by bills, which we think led to an overall lower interest cost. Resultant EBTDA/Interest was 5.9x in 1H2019 versus 5.2x in 1H2018. Our base case assumes that CENSUN would seek to return to market to raise a replacement bond to redeem the SGD-denominated CENSUN 7.0% '20s. Assuming this is raised at higher cost of funding, EBITDA/Interest would likely fall from the current levels.

Explanation of Issuer Profile Rating / Issuer Profile Score

Positive ("Pos") – The issuer's credit profile is either strong on an absolute basis, or expected to improve to a strong position over the next six months.

Neutral ("N") – The issuer's credit profile is fair on an absolute basis, or expected to improve / deteriorate to a fair level over the next six months.

Negative ("Neg") – The issuer's credit profile is either weaker or highly geared on an absolute basis, or expected to deteriorate to a weak or highly geared position over the next six months.

To better differentiate relative credit quality of the issuers under our coverage, we have further sub-divided our Issuer Profile Ratings into a 7 point Issuer Profile Score scale.

IPR	Positive		Neutral			Negative	
IPS	1	2	3	4	5	6	7

Please note that Bond Recommendations are dependent on a bond's price, underlying risk free rates and an implied credit spread that reflects the strength of the issuer's credit profile. Bond Recommendations may not be relied upon if one or more of these factors change.

Explanation of Bond Recommendation

Overweight ("OW") – The performance of the issuer's specific bond is expected to outperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Neutral ("N") – The performance of the issuer's specific bond is expected to perform in line with the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Underweight ("UW") – The performance of the issuer's specific bond is expected to underperform the issuer's other bonds, or the bonds of other issuers either operating in the same sector or in a different sector but with similar tenor over the next six months.

Other

Suspension – We may suspend our issuer rating and bond level recommendation on specific issuers from time to time when OCBC is engaged in other business activities with the issuer. Examples of such activities include acting as a joint lead manager or book runner in a new issue or as an agent in a consent solicitation exercise. We will resume our coverage once these activities are completed.

Withdrawal ("WD") – We may withdraw our issuer rating and bond level recommendation on specific issuers from time to time when corporate actions are announced but the outcome of these actions are highly uncertain. We will resume our coverage once there is sufficient clarity in our view on the impact of the proposed action.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Strategy & Research
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Wellian Wiranto
Malaysia & Indonesia
WellianWiranto@ocbc.com

Terence Wu
FX Strategist
TerenceWu@ocbc.com

Howie Lee
Thailand, Korea & Commodities
HowieLee@ocbc.com

Carie Li
Hong Kong & Macau
carierli@ocbcwh.com

Dick Yu
Hong Kong & Macau
dicksny@ocbcwh.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
WongHongWei@ocbc.com

Seow Zhi Qi
Credit Research Analyst
ZhiQiSeow@ocbc.com