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CMB INTERNATIONAL

Fixed Income
Credit Commentary

2 Sep 2022

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CENCHI: Relationship with Henan government, not 1H22 results, should be the focus

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Maintain buy on CENCHIs despite smaller upside

CENCHIs rebounded, along with the market, 14-23pts off the lows in mid Jul'22. That said, CENCHIs are still 6-13pts lower than the levels post signing the framework agreement with Henan Tongsheng Zhiye Co., Ltd (HTSZY) on the share transfer in early Jun'22. Over the past 3 months, we saw the 2 positive developments: 1) HTSZY's completion of acquiring 29% stakes from Chairman Wu to become the 2nd largest shareholder of CENCHI despite the market skepticism on the deal and "noise" in Henan; and 2) the full repayment of CENCHI 6.875%'22 (issue size of USD500mn) in full on 8 Aug'22. These demonstrated the firm commitment from the chairman and HTSZY to provide financial support in a very challenging operating and funding environment. As per CENCHI, HTSZY will complete the DD for CBs issue of HKD708mn by mid- to late-Sep'22. If the CBs will successfully be issued and fully converted, HTSZY will become CENCHI's largest shareholder, and CENCHI could be a consolidated entity of HTSZY. While liability management exercise is possible if business and funding environment do not improve, we believe that the current valuation of CENCHIs (mid-30s-to low-50s) have priced in the possibility of a liability exercise, taking cues of the valuations of peers such as CSCHCNs (mid-40s-to low-60s). Recalled that China South City recently extended maturities for 20 months and revised coupon rate to 9%. Hence, we maintain buy on CENCHIs despite the upside will be smaller after the sharp rebound since mid Jul'22. We expect the progress in CBs issue, asset monetization and collection of government receivables to the near-term catalysts.

First ever net loss reported, driven partly by non-operating losses

In 1H22, CENCHI's revenue declined 64% yoy to RMB7.3bn while recorded operating losses of RMB770mn in 1H22, compared with an operating profit of RMB2.1bn in 1H21. It turned to a net loss of RMB5.9bn in 1H22 from a net profit of RMB1.0bn in 1H21, reflected the industry downturn, partly triggered by COVID-19, as well as the non-operating losses (inventory write-down, valuation losses of investment properties, impairment losses on receivables and FX losses) totaled RMB4.1bn. This is the first net loss reported since its IPO in 2008. Its gross margin shrank to 7.6% in 1H22 from 17.9% in 1H21 (vs 14.7% in 2H21), respectively. The lacklustre 1H22 results were largely expected subsequent to the profit warning on 15 Aug'22.

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CENCHI has unrecognized sales of RMB71.7bn (incl sales of JCE) as at Jun'22. The gross margin of these unrecognized sales is 11%. Hence, we should see some pick-ups in recognized sales and profit margin going forward. In 7M22, its contract sales were RMB16.2bn, down 51% yoy. It completed c40% of its FY22 sales target of RMB40bn. To achieve the sales target, its sell-through rate will have to increase to 51% in 2H22 from 43% in 1H22. The sales target appears a bit challenging.

Asset monetization and funding access with the assistance of HTSZY are keys to liquidity

	Jun'21	Dec'21	Jun'22
Net gearing	99.2%	98.8%	319.1%
Adj liab/assets	87.2%	86.4%	92.9%
Cash/ST debts	190.5%	143.6%	58.4%
Unrestricted cash/ST debts	125.7%	86.1%	25.1%
MI/equity	24.0%	26.7%	45.6%

CENCHI's credit and liquidity profile weakened notably, reflected the smaller equity base after the net losses in 1H22 and negative free cash flow. We expect some improvement in its credit and liquidity profile in 2H22, supported by the CB issues and collection of government receivables of RMB1-2bn in 2H22. CENCHI expects to generate cRMB2-3bn from asset monetization through the sales of management rights of commercial properties and stakes in culture and tourism projects. The sales of project stakes could also help deconsolidate debts. That said, time table of asset monetization remains fluid. CENCHI guided a positive free cash flow in 2H22 and increase in unrestricted cash to cRMB4.7bn by Dec'22 from cRMB2.8bn in Jun'22. We believe that a more notable improvement for CENCHI's liquidity profile to come after HTSZY becoming the largest shareholder of CENCHI. This should notably improve CENCHI's funding access with an even more active involvement of HTSZY. Recalled that HTSZY is wholly-owned by Henan Railway (HNRAIL, rated A2 by Moody's). HNRAIL, in turn, is wholly-owned by Henan government and is the sole entity in Henan designated by the Henan government to invest in railways and is responsible for the investment, construction and operation management of railways in Henan.

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