Shougang Group Co., Ltd.

Surveillance Report

SRIR15104020180111/3401

Summary

Category	Surveillance Report
Location	China
Industry	Steel
GICS	151040
Issuer rating	A
Outlook	Stable
Date	10 JAN 2018

Rating Description

Dagong HK maintains its global scale long-term issuer credit rating of "A" to Shougang Group Co., Ltd. (hereinafter referred to as "Shougang" or "the company") with a stable outlook over the next 12 months.

We maintain our A rating with a stable outlook on Shougang given that there has been no material change since our last assessment in November 2016. The stable outlook reflects our expectation that Shougang would likely maintain its leverage and access to capital, as well as receive external support from the Beijing Municipal Government in time of need, in the next 12 months. Furthermore, we assume the Chinese economy would grow in the range of 6.5% to 7% for 2018.

Rating Outlook

Downgrade Scenario

We would downgrade the company if we believe the net economic value Shougang would generate from its land redevelopment projects is much less than our base case scenario as a result of an unexpected a collapse of Beijing's property market.

Upgrade Scenario

The upgrade potential is limited for the next year, in our judgment. We would raise the rating if the company substantially reduces its financial leverage by reducing its Gross Debt/EBITDA ratio to below 4x, which could be achieved by (1) a substantial and sustainable steel price rebound in China; or (2) a debt repayment through proceeds from a sale of its land re-development projects.

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Industry Development over the Past Year

We believe the key drivers affecting Chinese steel industry's credit assessment such as 1) product prices; 2) speed of China's urbanization and 3) effectiveness in addressing the industry's excessive capacity, remain within our last assessment performed on 21 November 2016. We see little evidence pointing to a material change to these factors, versus our previous assessment made on 21 November 2016.

Recovering steel prices

As noted in our previous assessment report, China's steel prices bottomed in 2015, showing continuous improvement throughout 2016-17, primarily due to reasons mentioned above. As of 30 November 2017, hot-rolled and cold-rolled steel prices posted 135%/111% increases, respectively, versus 2015 and reaching the 2012 levels. The price gains were 21%/9% for both products over the past year.

However, we do not expect further dramatic increases in the coming years, due to overcapacity of steel production in China. The steel industry is still overall over supplied and near-term price volatility should primarily be driven by the Chinese government's campaign to close excessive capacities and curb environmental pollutions.

According to a recent forecast made by the China Metallurgical Industry Planning and Research Institute, China's steel products demand may increases 0.7% to 730mn tons in 2018, versus an increase of 7.7% in 2017. Crude steel production may rise by 0.7% to 838mn tons in 2018, versus an increase of 3% in 2017, according to the industry forecast agency.

EXHIBIT 1

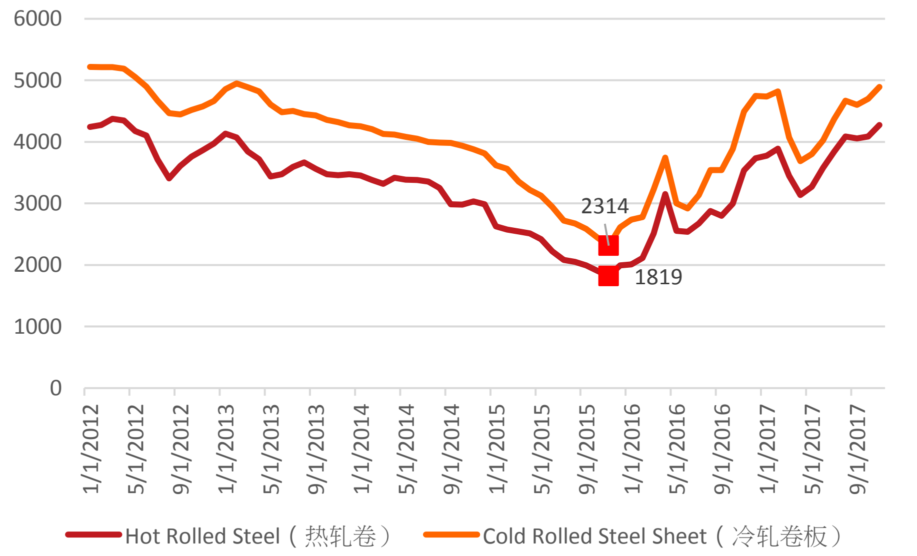
Steel Product Production & Demand in China

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
China Steel Products Output (Mil. mt)	497.9	566.4	626.5	684.3	708.8	774.6	813.3	800.5	806.7	711.8
China Steel Products Demand (Mil. mt)	454.4	561.1	598.4	651.1	673.9	752.7	738.0	694.7	711.5	658.2

Source: Bloomberg

EXHIBIT 2

Historical Steel Price in China



Source: Bloomberg

Slowing economic growth, but still expanding at a relatively high speed

According to data from the National Bureau of Statistics (NBS), China's 3Q17 GDP totaled RMB 21,179.8bn, registering a YoY increase of 6.8%. The growth rate has slowed from 8.1% in 1Q12 and 7% in 2015, but is still at a higher level compared with the G7 countries. We expect China's GDP growth to be in the range of 6.5%-7% in 2018 as one of the key drivers supporting demand in some industrial materials such as steel.

EXHIBIT 3

China GDP YoY %

Year	Q1	Q2	Q3	Q4
2012	8.1	7.6	7.5	8.1
2013	7.9	7.6	7.9	7.7
2014	7.4	7.5	7.1	7.2
2015	7.0	7.0	6.9	6.8
2016	6.7	6.7	6.7	6.8
2017	6.9	6.9	6.8	

Source: China NBS

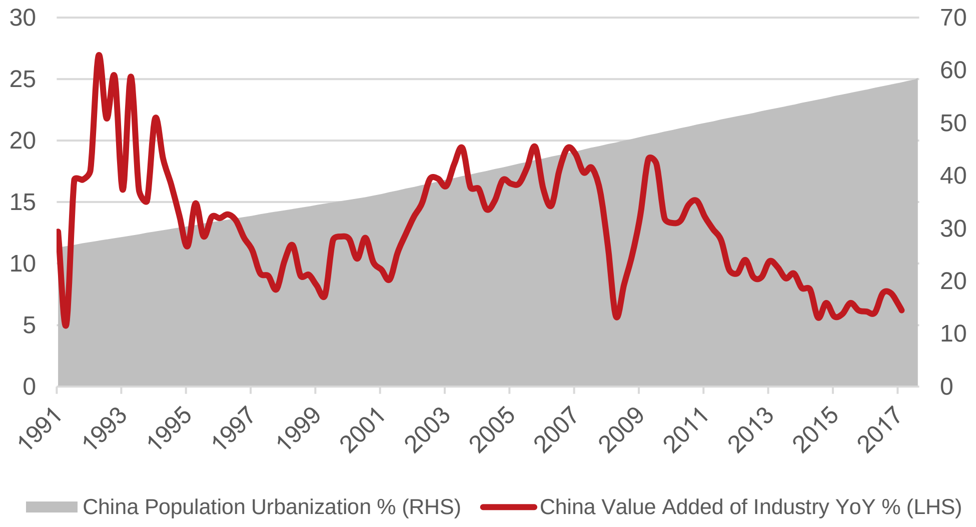
Urbanization and industrial demand

China is still under an urbanization process and that's another important driver of China's demand for steel products. Based on the NBS data, the number of urban cities reached 657 as of end-2016 and permanent residents living in cities accounted for 57.4% of the country's total population. We expect this ratio to further increase to 70% to match the average level of developed countries.

Industrial activities in China are still growing but similar to the GDP pattern, the growth rate has moderated. Official data shows China's 3Q17 industrial output growth was 6.7% YoY, versus 6.1% in 3Q16 and average 10.3% in the past 10 years.

EXHIBITS 4

China Population Urbanization & Value Added of Industry YoY%



Sources: Bloomberg, China NBS

Capacity closure

The Chinese government has demonstrated decisive commitments to reduce the country's excessive and outdated steel capacities in order to balance the market and at the same time to address the pollution issues. Steel plant closures have been the primary reason of some near-term price volatility in the past year and we expect this to continue going forwards. Key events or timing of typical steel plant closures include the winter time when pollution worsens in northern China and some high-level government conferences like the NPC/CPPCC sessions in March and October.

Company Operations Update

The major factors for Shougang's company-specific assessment include its equipment quality & technology standard, product portfolio, R&D targets, environmental and efficiency parameters, capacity utilization, profitability and cash conversion cycles, etc. We have not seen material changes to the above factors over the past year.

The key operational developments since our last credit review are:

1) Completing closure of steel mills outside its core asset locations of Beijing and Hebei in order to increase asset efficiency. We do not expect a major impact on Shougang's total production capacity due to the small size of closed capacity in these regions. The company's total steel production capacity is about 30mn tons and its equipment metrics stay largely unchanged versus our previous assessment.

2) Continuing the expansion projects under the Phase II plans of Jingtang plant; and

3) Starting the property project development at its old production base in Beijing.

These are all well expected and guided by the company over the past year and did not lead to any major changes to its product portfolio or asset quality, in our view.

Shougang's profitability improved over the past year, primarily because of the steel price recovery. This was also within the range of our industry expectations.

The company's key credit metrics have shown improvement in 2016-2017, as expected. EBITDA margin increased to 9.7% in 2016, versus an average of 6.6% in the previous two years. EBITDA interest coverage ratio also increased to 1.7x in 2016, versus 1.4x/1.3x in 2014/2015 respectively. Gross debt over capitalization was 70.6%, compared with 65%/70.5% in 2014/2015 respectively.

Overall, we do not believe the operational and financial updates from Shougang should justify any rating adjustments over the past year. We hence maintain our previous stand-alone credit assessment (SACA) for Shougang of "bb".

EXHIBIT 5

Shougang's revenue, gross profit and net income for 2015 and 2017 (in RMB 00,000,000)

Year	2015	2016	2016 first 9 months	2017 first 9 months
Revenue	1352	1348.70	955.27	1326.18
Gross profit	-37.47	7.85	-4.12	8.75
Net income	-29.13	-12.47	-3.50	4.90

Source: Company data

EXHIBIT 6

Shougang Group's Three Year Financial Highlights

Financial Highlights			
Fiscal year as of	**30-Dec-16**	**30-Dec-15**	**30-Dec-14**
(Millions of RMB, Adjusted Financials)			
Revenues	134,710.0	135,200.6	182,788.6
EBITDA	13,057.2	8,708.0	12,440.7
Funds from Operations (FFO)	4,284.5	1,518.1	2,880.6
Net Income	(1,246.7)	(2,913.0)	(845.2)
Cash Flow from Operations	2,709.7	1,750.6	1,913.3
Capital Expenditures	8,152.8	7,093.0	6,989.5
Free Cash Flow (FCF)	(5,443.1)	(5,342.4)	(5,076.2)
Cash and Short-term Investments	33,683.2	41,471.7	26,228.1
Gross Debt	249,841.3	244,164.7	209,611.5
Total Assets	446,179.4	437,023.7	409,531.6
Total Equity	99,692.7	99,144.7	110,475.9
Adjusted Financial Ratios			
EBITDA Margin (%)	9.7	6.4	6.8
Return on Assets (EBIT/ Average Total Assets) (%)	1.5	0.4	1.8
EBITDA/Interest Expense (x)	1.7	1.3	1.4
Gross Debt/EBITDA (x)	19.1	28.0	16.8
Gross Debt/Capitalization (%)	70.6	70.5	65.0
(FOCF - ST Debt)/Total Equity (%)	(138.0)	(132.1)	(100.4)
Quick Ratio (x)	0.3	0.3	0.3
Cash & Short-term investments/ Short-term debt (x)	0.3	0.3	0.2

Source: Company data, Dagong HK's Estimates

Government Support

We continue to assess Beijing Municipality Government to have very strong willingness and capability to support Shougang, based on historical evidences and recent update from the company. We maintain the six-notch uplift to ‘A’ from Shougang’s SACA of ‘bb’ due to the very strong government support willingness and this reflects our expectation of very high likelihood of extraordinary supports from the Beijing Municipal Government in the event of financial distress. We continue to expect Shougang’s close linkage with the Beijing Municipal Government and its importance should be sustained in the next two to three years.

Our government support assessment is based on:

1. The government does not intend to privatize or restructure the GRE in the long-term. Shougang is one of the leading steel producers in China and is also one of the most important SOE under the Beijing State-owned Asset Supervision and Administration Commission. We do not expect the Beijing government has any reasons to privatize or restructure Shougang in the long term.

2. The GRE’s business activities are guided or influenced by the government’s policies. Major development strategies of Shougang have been largely influenced by the Beijing and central government, recently evidenced by government’s requirement to relocate some of its production facilities to outside Beijing.

3. The government is a majority shareholder of the GRE and has a direct control on the GRE’s business decisions such as appointing and removing the GRE’s board/management. The Beijing government holds 100% stake in Shougang. The appointment mechanism of Shougang’s top management also reflects a high-level of political arrangement, in our view. The Beijing Communist Party’s organization department over the past year started appointing all the key management team with seniority of VP and above (approximately 18 members), compared with only the chairman and president previously.

4. The government provides substantial subsidies and/ or guarantees to the GRE. Shougang is one of the local SOE with the largest state capital injections. It has received a large amount of government subsidies in multiple forms over the past years. Supported by the Beijing and central government, Shougang obtained a large amount of high quality land resources in order to meet its expansion plans largely required by the governments. The state policy banks like the China Development Bank also provide a large amount of low-cost financing to Shougang’s developments.

5. The government had provided massive support(s) to Shougang in the past, and has no significant change for the conditions of triggering such supports, in our view. Supported by the Beijing and central government, Shougang obtained a large amount of high quality land resources in order to meet its expansion plans largely required by the governments.

Rating Metrics

Shougang Group's "A" long-term global scale issuer credit rating is based on our assessment of the company's standalone credit profile. The table below, EXHIBIT 7, shows the details of the rating metrics on Shougang.

EXHIBIT 7

Shougang Group – Rating Metrics

Rating Factors	Weight	Rating
I. Operating Environment	**6.0%**	aa
II. Wealth Creation Capacity	**47.0%**	
Market Opportunities	11.8%	bbb
Competitive Position	21.2%	bbb+
Profitability		
EBITDA Margin	8.4%	bbb
Return on Assets	5.6%	b
III. Debt Servicing Capacity	**47.0%**	
Debt/Capitalization	9.4%	b
(FCF-Short-term debt)/Equity	6.1%	ccc
Debt/EBITDA	13.7%	ccc
EBITDA Interest Coverage	10.7%	b
Quick Ratio	7.1%	ccc
IV. Deviation Index		**bb**
V. Industry Risk		**bb**
	Base	**bb**
VI. Modifiers		
Debt Structure and Financial Policy		Neutral
Liquidity		Neutral
Comprehensive Analysis		Neutral
Strategy and Corporate Governance		Neutral
Stand-Alone Credit Assessment (SACA)	**100.0%**	**bb**
VII. External Support		
Corporate Entity Support		Neutral
Government Support		+6 notches
Issuer Credit Rating (ICR)		**A**

Rating Methodology

The principal methodology used in this rating is Dagong HK's Corporate Methodology published in March 2017 and revised on 15 November 2017, which can be found at the website www.dagonghk.com.

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