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Research Update:

China State Construction Engineering Corp. Ltd. 'A' Ratings Affirmed; Outlook Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Issue Ratings--Subordination Risk Analysis

Related Criteria

Ratings List

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Overview

- We believe China-based CSCEC will maintain its competitive advantages in major construction projects and large-scale real estate development.
- The group's ability to generate cash flow from conventional E&C will, in our view, provide a good buffer against rising leverage from increased real-estate development.
- We are affirming our 'A' long-term issuer credit rating on CSCEC and our 'A' long-term issue rating on the notes that the company guarantees.
- The stable outlook reflects the company's strong ability to acquire new projects or adjust its backlogs to provide buffers against industry volatility or avoid a rise of leverage over the next two years.

Rating Action

On June 12, 2018, S&P Global Ratings affirmed its 'A' long-term issuer credit rating on China State Construction Engineering Corp. Ltd. (CSCEC). The outlook is stable. We also affirmed our 'A' long-term issue rating on the outstanding senior unsecured notes that CSCEC guarantees.

Rationale

We affirmed the rating because we expect CSCEC's stable cash flows from its conventional engineering and construction (E&C) segment will enable the company to manage a likely rise in financial leverage due to increased real-estate development over the next two years. Its real estate activities are mainly led by its 61%-owned subsidiary, China Overseas Land & Investment Ltd. (COLI).

We also anticipate that CSCEC's overall profitability will remain good. The company's strong competitive position is supported by its leading position in large complex construction projects in China and a good track record of acquiring new contracts. We do not anticipate this advantage to change, given the company's design ability, technology skill sets, and financial buffers. Further, CSCEC's property development segment has a substantial land bank (primarily through COLI) in the country's top tier cities.

We note that CSCEC's growth drivers are changing and this will change the company's working capital dynamics. Its new E&C contracts grew by 24% in 2016

and 18% in 2017, and property contract sales grew by 22% and 21% respectively, suggesting very healthy revenue growth over the next two years. Property development tends to have a longer payback period than conventional E&C. On the other hand, CSCEC's E&C segment is increasing focusing on build-transfers (BT) and public-private partnerships (PPP), which have higher profit margins but longer accounts-receivable days. We estimate BT and PPP projects contributed 10%-20% of E&C revenues over the past two years.

We believe CSCEC's strong competitive advantages can support its portfolio adjustment, so that the company can be more selective on new contracts. It can also adjust its existing backlogs to shorten payback periods, for example to speed up receivables collections or even investment buy-backs. In our view, this flexibility could enable the company to comply with the Chinese central government's corporate deleveraging mandate. Most of CSCEC's newly acquired investment projects are infrastructure projects in the form of PPP for local governments with the same mandates to control leverage. CSCEC reported a ratio of debt to EBITDA of 3.3x in 2017, a mild decline from 3.5x in 2016.

CSCEC should maintain its stable profitability over the next two years, given that we expect a rising contribution of higher-margin businesses such as infrastructure E&C and property development. Its EBITDA margin rose to 7.3% in 2017 from 6.6% in 2016, where major segments, including housing E&C, infrastructure E&C and operations, and property, all reported stable or improving margins.

Our base case assumes the following:

- China's real GDP to grow by 6.5% in 2018 and by 6.3% in 2019.
- Infrastructure construction and investment will remain an important government focus to sustain GDP growth but we expect a temporary slow-down of new project releases due to the central government's mandate for corporate deleveraging.
- CSCEC's revenue to rise by 8%-12% in 2018 and 2019, driven by its satisfactory backlogs for E&C and property sales.
- Its EBITDA margin to be 7.0%-7.5% in 2018 and 2019, in line with 2017 levels. Stiff competition especially in the property segment can be mitigated by a change in product mix with more contribution from higher-margin property and infrastructure projects.
- CSCEC's annual net working capital outflow to be Chinese renminbi (RMB) 50 billion-RMB70 billion in 2018 and 2019, mainly due to continued growth in property projects, which require funds during the construction phase. On the other hand, we expect its E&C segment to report a negligible working capital outflow in view of its very stable cash inflows from conventional E&C and effective collection on long-term receivables for investment-linked E&C.
- Annual capital expenditure to be around RMB20 billion.
- Annual cash dividends to be RMB12 billion-RMB15 billion.

Based on these assumptions, we arrive at the following credit measures for 2018 and 2019:

- Debt-to-EBITDA ratio of 3.0x-3.5x, from 3.3x in 2017
- Ratio of funds from operations (FFO) to debt of 15%-25%, from 17.9% in 2017
- EBITDA interest coverage of 4.5x-5.0x, from 4.4x in 2017.

Liquidity

We assess CSCEC's liquidity as adequate on a stand-alone basis because we expect the company's liquidity sources to exceed its uses by more than 1.2x over the next 12 months. Net liquidity sources should remain positive even if CSCEC's forecast EBITDA declines by 15%.

CSCEC's state-owned enterprise (SOE) link allows it to maintain good relationships with banks, as indicated by its wide bank connections and sufficient bank facilities for use. Our assessment further considers the company's possibility of higher acquisitions for investment or land, which are unlikely to be absorbed without refinancing.

Principal liquidity sources include:

- Cash and short-term investments of about RMB260 billion at the end of 2017.
- Estimated cash FFO of RMB50 billion-RMB60 billion in 2018.

Principal liquidity uses include:

- Short-term debt maturities of about RMB70 billion in 2018.
- Net working capital outflow of RMB50 billion-RMB70 billion, mainly driven by property operations, during the period.
- Capital expenditure, committed investment (mainly in form of PPP) and committed land premiums of RMB25 billion-RMB30 billion in the period.

Outlook

The stable outlook on CSCEC reflects our expectation that the company's strong market reputation and solid SOE links will support its ability to acquire new contracts and adjust its backlogs to achieve a new balance between growth and leverage-control. We believe the company's cash flow metrics will be generally stable, including the ratio of debt to EBITDA at 3.0x-3.5x over the next two years. At the same time, the company's shift toward higher margin products and good project execution will continue to support its profit margins as well as an EBITDA coverage ratio at 4.5x or above.

Downside scenario

We could downgrade CSCEC if market conditions or an overly aggressive business expansion cause the company's profit margins to decline or its receivable-collection days to lengthen. This pressure would be indicated by the debt-to-EBITDA ratio deteriorating to 3.5x or above or its EBITDA coverage declining to 4.5x or below.

We could also consider a downgrade if the government divests its shareholding to substantially below 50%, or the company's policy-driven activities can be easily replaced by other SOEs, thus weakening our assessment of government support.

Upside scenario

We could upgrade CSCEC if the company can further enhance its financial discipline, while keeping an excellent competitive position and satisfactory working capital management. This could be achieved if the company can deleverage its balance sheet to keep its debt-to-EBITDA ratio consistently at 2x or below, or significantly improve its profit margin to achieve an EBITDA interest coverage at 6x or above. We view this probability as relatively the low over next two years.

Ratings Score Snapshot

Issuer Credit Rating: A/Stable/--

Business risk: Strong
- Country risk: Moderately high
- Industry risk: Moderately high
- Competitive position: Excellent

Financial risk: Significant
- Cash flow/Leverage: Significant

Anchor: bbb

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Positive (+1 notch)

Stand-alone credit profile: bbb+

- Related government rating: A+
- Likelihood of government support: High (+2 notches from SACP)

Issue Ratings--Subordination Risk Analysis

Capital structure

CSCEC's capital structure as of end-2017 consists of around RMB77 billion of secured debt, RMB73 billion of unsecured debt at the parent level, and RMB236 billion of unsecured debt issued by the company's operating subsidiaries.

Analytical conclusions

We equalize our issue rating on the company's U.S.-dollar-denominated unsecured debt issued by CSCEC's special purpose vehicle, with our 'A' issuer credit rating on CSCEC. Despite a significant amount of priority debt in the capital structure, we believe the risk of subordination is mitigated by our view that the government would likely intervene in the bankruptcy process. We expect a high likelihood of extraordinary support from the Chinese government directly to CSCEC if necessary, and believe that the government is willing and able to intervene so that structurally subordinated lenders would not have lower recovery prospects than structurally senior lenders.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology And Assumptions: Assigning Equity Content To Hybrid Capital Instruments Issued By Corporate Entities And Other Issuers Not Subject To Prudential Regulation, Jan. 16, 2018
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Homebuilder And Real Estate Developer Industry, Feb. 3, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Engineering And Construction Industry, Nov. 19, 2013

- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Timeliness Of Payments: Grace Periods, Guarantees, And Use Of 'D' And 'SD' Ratings, Oct. 24, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Insurance - General: Hybrid Capital Handbook: September 2008 Edition, Sept. 15, 2008

Ratings List

Ratings Affirmed

China State Construction Engineering Corp. Ltd.	
Issuer Credit Rating	A/Stable/--
CSCEC Finance (Cayman) I Ltd.	
Senior Unsecured	A
CSCEC Finance (Cayman) II Ltd.	
Senior Unsecured	A

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