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How Financially Resilient are Construction Machinery Leaders amid Sales Bottoming?

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Key Takeaways

- We see continued downward pressure on construction machinery sales over the next year. Weak recovery for domestic demand coupled with volatile export policy may suppress the positive momentum for the sector. In this context, key risks facing manufacturers in this sector would be dented profitability, bad debt loss associated with credit sales, and obligations of guaranteed repurchase.
- Chinese construction machinery manufacturers bear significantly higher leverage than their international peers. Given the strong cyclicality for the sector, a highly leveraged manufacturer may find its financial profile rather fragile at the trough of an industrial cycle.
- Our stress testing shows that industrial leaders such as Xugong Group, Zoomlion, SANY Group, Liugong Group, and Shantui, albeit facing high leverage like others, are likely to maintain adequate liquidity in the next year and enjoy certain degree of resilience against risks induced by increased repayments under repurchase guarantee and earnings fluctuations.

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Amid the cyclical trough for China's construction machinery sector, how financially resilient are domestic manufacturers and how severe is the liquidity stress they've encountered? Taking on a downward trajectory since 2022, the sector is expected to face continued challenge from sales slide over the next year. Despite the upcoming replacement cycle for construction machinery, the consistent shrinkage in real estate investment remains a major obstacle slowing down sales recovery, with growing uncertainty over policy and market environment for exports. Weak recovery for domestic demand coupled with volatile export policy may have a continuous impact on construction machinery manufacturers. Such market conditions would inevitably cause persistent swing in financial risks and liquidity pressure faced by these manufacturers. Volatile sales and earnings, and potential risks related to bad debt loss and repurchase guarantee under credit sales mode would become critical challenges for market incumbents. We expect to see further divergence of credit quality across the industry in 2024. Leading companies should sustain adequate liquidity thanks to their solid ability to export products and manage costs, whereas companies at weaker position in the industry may be troubled by more severe situations such as substantially suppressed sales and dented profitability.

Chart 1

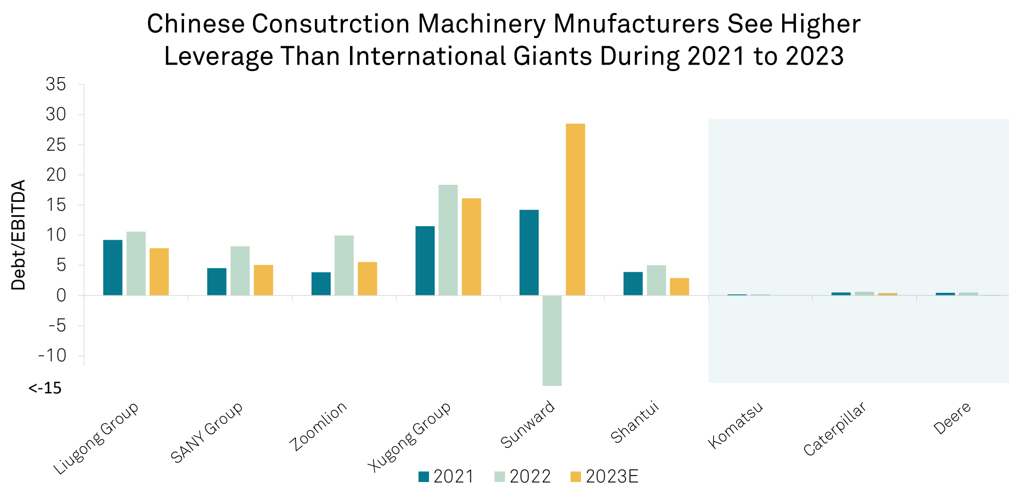
Source: CCMA, Wind, S&P Global (China) Ratings.

Financial Pressure Generally Up amid Down Cycle, Markedly Higher Leverage Compared to Overseas Giants

During the current industrial downturn, leverage has moved up in general across the sector, primarily owing to the volatility in EBITDA. For construction machinery manufacturers, the sharp changes in EBITDA during the downward cycle are partly attributable to revenue fluctuations and partly to a rise in average expense due to reduced economies of scale.

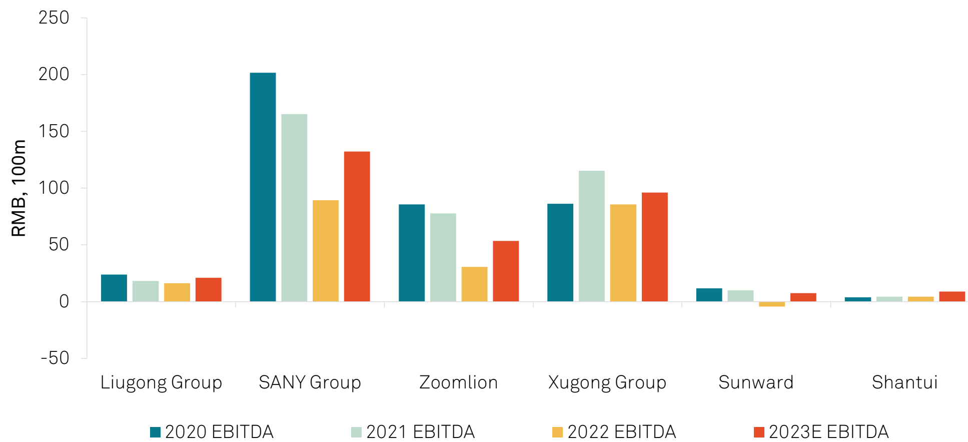
We observe from peer comparison that Chinese construction machinery companies' leverage is higher on average compared to international leaders. The three global giants - Komatsu, Caterpillar, and Deere - have maintained their leverage ratios within a comfortable range of 0.1-0.6x. This is because they have stable and solid ability to generate free cash flow, thus building almost a net-cash position to strengthen their financial profiles. These sound financial conditions render them highly resilient against risks pertaining to the sector's strong cyclicality. However, even during the time of surging sales, domestic manufacturers still have higher leverage than international peers.

Chart2



Note: 1. All data adjusted by S&P Global (China) Ratings or S&P Global Ratings. 2. E- Estimate. 3. Fiscal year for Komatsu starts on April 1 and ends on March 31 of the next year, applied throughout. 4. Fiscal year for Deere ends on October 31, applied throughout. 5. A 25% cash discount rate uniformly applied for Chinese companies, and entity-specific cash discount rate applied for each international company based on actual situations, applied throughout.
Source: public information, S&P Global (China) Ratings, CIQ.

Chart 3



Note: E - Estimate
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Credit Sales Continue, Financial Strains Heightened by Obligations of Guaranteed Repurchase

In our view, construction machinery companies still rely mainly on credit sales during the present cycle, and we don't see considerable mitigation in risks related to repurchase guarantee and bad debts for most of our sampled entities. Following the liquidity squeeze during the last round of down cycle, these companies have taken a series of countermeasures, e.g. higher percentage of down payment and stricter credit quality check for customers, in a bid to lower risks from credit sales. Nonetheless, due to the limited base of high-quality customers, only manufacturers with strong sales capability and prominent market position are able to apply stringent criteria for selecting customers. Therefore, to what degree would a company reduce its reliance on credit sales is determined by its market position and sales strengths. We note that except for Zoomlion and SANY Group, who have seen smaller scale of repurchase guarantee and improved days of accounts receivable compared to the levels during the last cycle, other manufacturers still depend heavily on credit sales. Overall, the outstanding repurchase guarantee scale for the sector hits new high, with days of accounts receivable gradually climbing.

Construction machinery manufacturers' reliance on credit sales may translate into two types of risks pertaining to: 1) collection of accounts receivable, which is mainly derived from instalment sales mode, and 2) obligations of guaranteed repurchase, due to guarantees made for mortgages and financial leasing deals. These risks may be amplified when customers' repayment capabilities deteriorate during the cyclical trough of the sector.

Chart 4

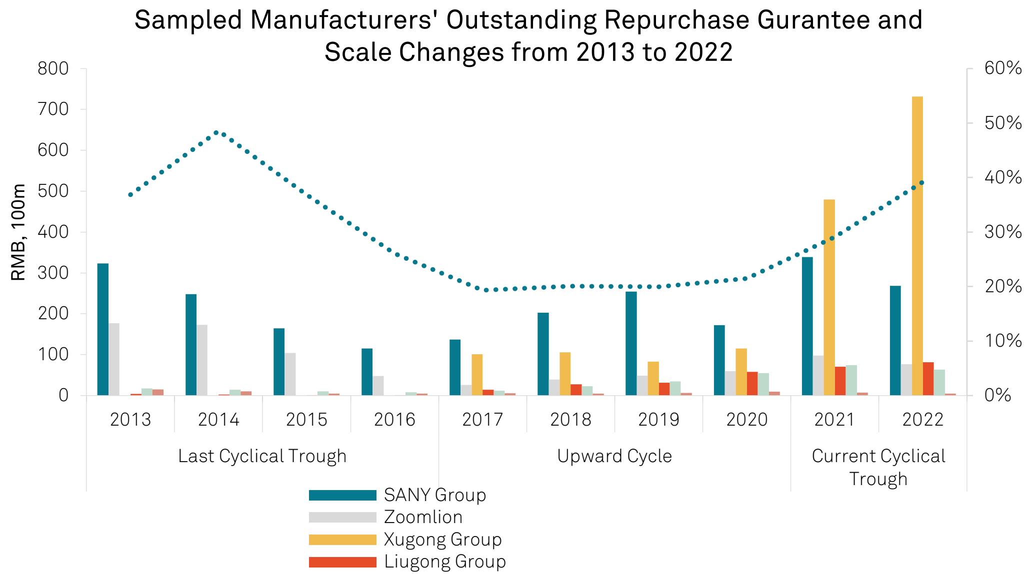

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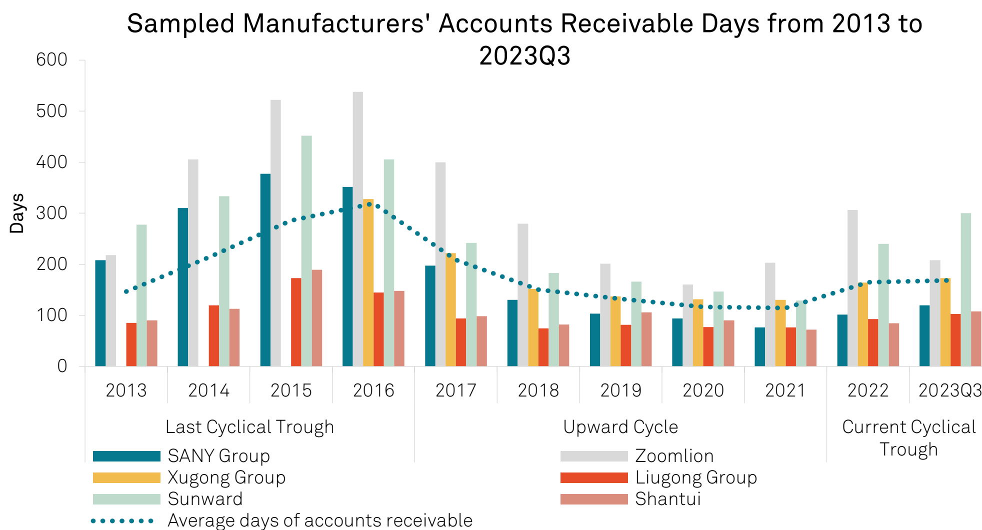
Chart 5



Note: 2013 to 2015 data not disclosed for Xugong Group.
Source: public information, S&P Global (China) Ratings.
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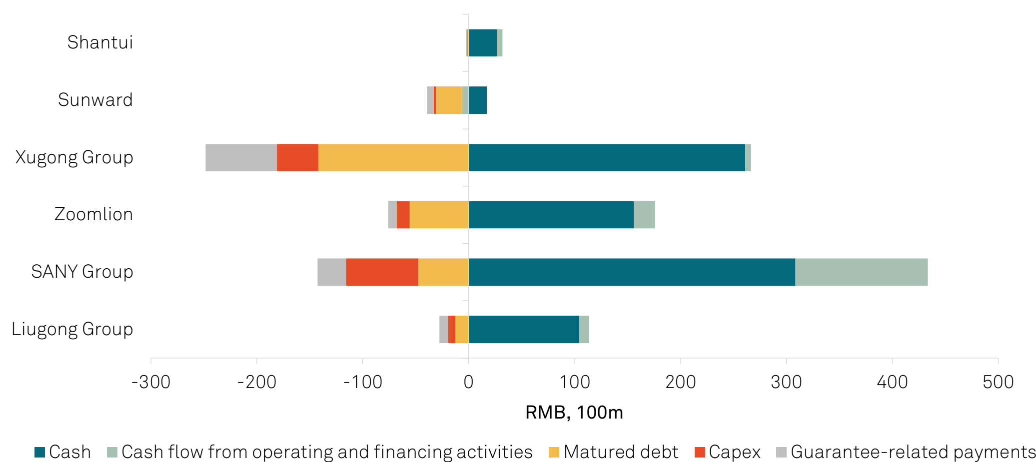
Most of Sampled Entities Expected to Maintain Adequate Liquidity Under Stress Over the Next Year

We expect construction machinery companies to see diverging financial and liquidity risks. Albeit facing leverage pressure like other manufacturers, four industrial leaders, i.e. Xugong Group, Zoomlion, SANY Group, and Liugong Group, would maintain sufficient liquidity in the next year, according to our liquidity projection. Shantui, despite its small scale, enjoys ample cash and small debt size, thus limiting its liquidity pressure to a low level. Therefore, these companies have a certain degree of tolerance to risks arising from increased repayments under repurchase guarantee and earnings volatility. Notably, weaker manufacturers in the industry could face more severe challenges from sales shrinkage and weakened profitability, adding to the overall liquidity

strain on the sector. Those with weaker overseas competitiveness or heavily indebted would bear the brunt.

Chart 6

Breakdown of Sources and Uses of Liquidity as of End of 2023Q3



Note: 1. This chart represents one-year forward sources and uses of liquidity starting from the end of 2023Q3. 2. Cash flow from operatig and financing activities is the sum of net cash flow from operating activies and relevant interest expenses. 3. Assumptions: 1) guarantee-related repayment ratio is 10%; 2) SOEs' short-term borrowings are fully rolled over and non SOEs' short-term borrowings decrease by 15%.
Source: public information, S&P Global (China) Ratings.
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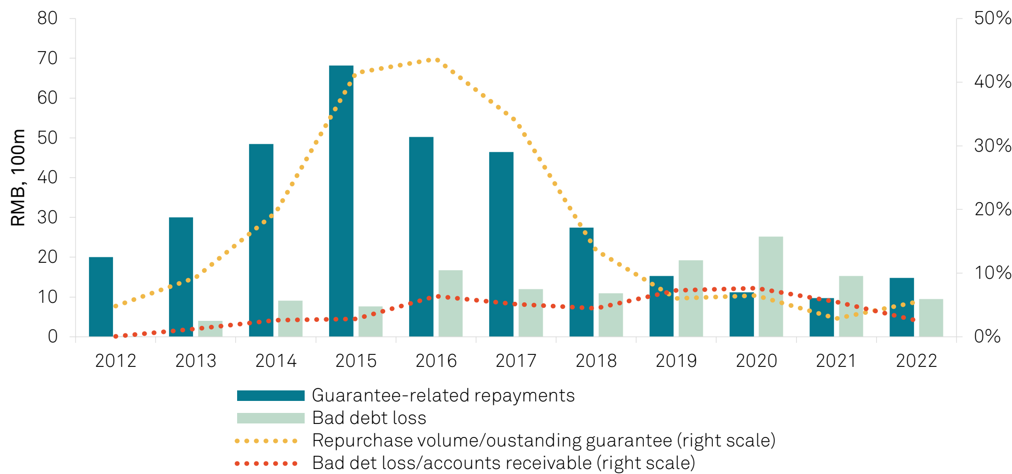
We stress test six major construction machinery manufacturers listed or issuing debt on the open market to see whether they could sustain their liquidity at a sufficient level in case of increasing repayments related to repurchase guarantee and significant decline in EBITDA margins.

We select the above two metrics as the inputs for stress testing given that they are the major contributors to the uncertainty over liquidity for the sector. For instance, SANY Group made massive repayments under repurchase guarantee and suffered bad debt loss during the last round of downward cycle, which led to increasing liquidity needs and worsened its liquidity profile. Historically, total repayments of customers' delinquent mortgages, financial leasing payables, and repurchases once reached about 40% of SANY Group's outstanding guarantee volume. Such payment scale has only begun to reduce since 2018. The company booked repurchase payments in loss reserves for bad debts, pushing its bad debt loss to 7-8% during the last industrial downturn. Another important factor affecting liquidity is EBITDA margin. If these companies see their EBITDA margins slide further, their working capital would turn negative, triggering a larger scale of operating cash outflow and thus increasing their burden to make cash expenses.

Chart 7



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Our stress testing suggests that most sampled companied would not be significantly impacted by repurchase guarantee obligations and profit slippage over the next year. For SANY Group, Zoomlion, Liugong Group and Shantui, adequate cash on hand and low risk of debt maturity concentration provide a buffer against such adversities. Xugong Group sees massive debt maturing within one year and may see a funding gap under severe stress, e.g. a sharp fall in profitability. Yet its stable access to refinancing may help meet its funding needs in a timely manner. Xugong Group is a critical SOE in Xuzhou, with a 91% stake directly owned by Xuzhou SASAC. As one of the largest SOE manufacturers in Xuzhou, Xugong Group has made a significant contribution to the city's fiscal revenue. We expect it to receive support from the Xuzhou government in terms of incentive policies and business operation and to sustain access to financial resources from local institutions in times of stress.

Some weaker companies may come under greater financial and liquidity pressure as the industry stays at the bottom, whereas SOEs may navigate this cyclical trough more easily with financial support from the governments. For instance, our liquidity stress testing for Sunward shows that the company's cash position cannot fully cover its non-current liabilities maturing within one year. Moreover, its cash generation capability is restricted, owing to its weak profitability and substantial needs of working capital. This led to a net operating cash outflow over the past three years, further eroding its cash stability. Nonetheless, the company's controlling shareholder is Guangzhou Wanli Investment Holding Co., Ltd and its de facto controller is the Guangzhou government. In our view, Guangdong enjoys solid financial strengths and Guangzhou is particularly strong in coordinating various financial resources, which may help ease the tight liquidity conditions of the company to a certain degree. Looking ahead, we will keep a close watch on its incremental loans, profitability improvement, and working capital management from 2024 through 2025, which are the key aspects for the company in addressing the liquidity challenge.

Chart 8

Liquidity under a 10% Fulfillment of Repuhase Obligations and EBITDA Stress Scenarios from 2023Q3 to 2024Q3

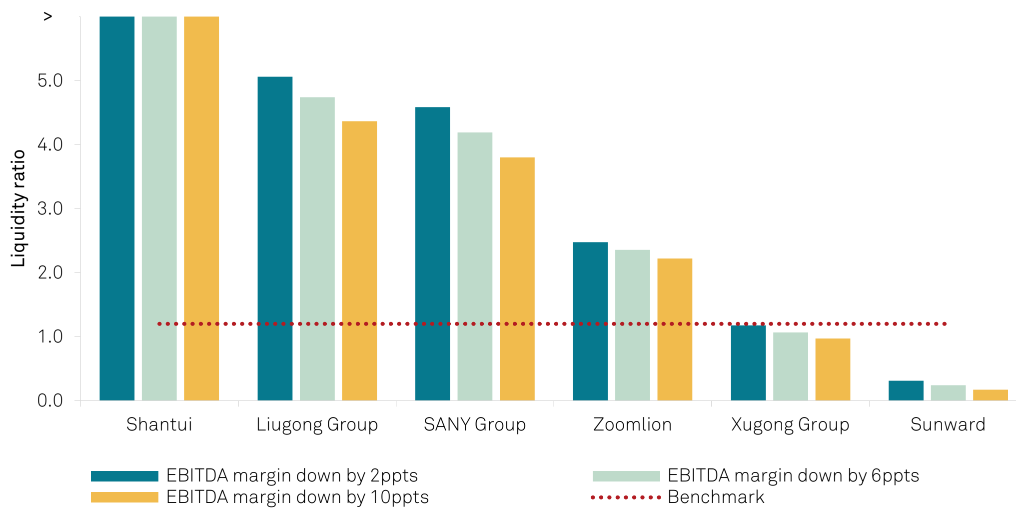

Chart 9

Liquidity under a 30% Fulfillment of Repurchase Oligations and EBITDA Stress Scenarios from 2023Q3 to 2024Q3

Note:

1. Liquidity ratio = sources of liquidity/uses of liquidity.
2. Sources of liquidity include cash and cash flow from operating activities. Uses of liquidity include matured debt, capital expenditures, and payments related to guaranteed repurchase.
3. Liquidity coverage ratio greater than 1.2x indicates adequate liquidity.
   Liquidity coverage ratio between 1-1.2x indicates tight liquidity.
   Liquidity coverage ratio between 0-1x indicates insufficient liquidity.
4. We make the following assumptions in our liquidity analysis:
   - 20% of capex is sourced from self-owned funds and 80% from external financing.
   - SOEs' short-term borrowings are fully rolled over and non-SOEs' short-term borrowings decrease by 15%.
   - No new loans are added, so that we can project the company's ability to cover uses of liquidity with its endogenous sources of liquidity under severe stress.

Source: public information, S&P Global (China) Ratings.

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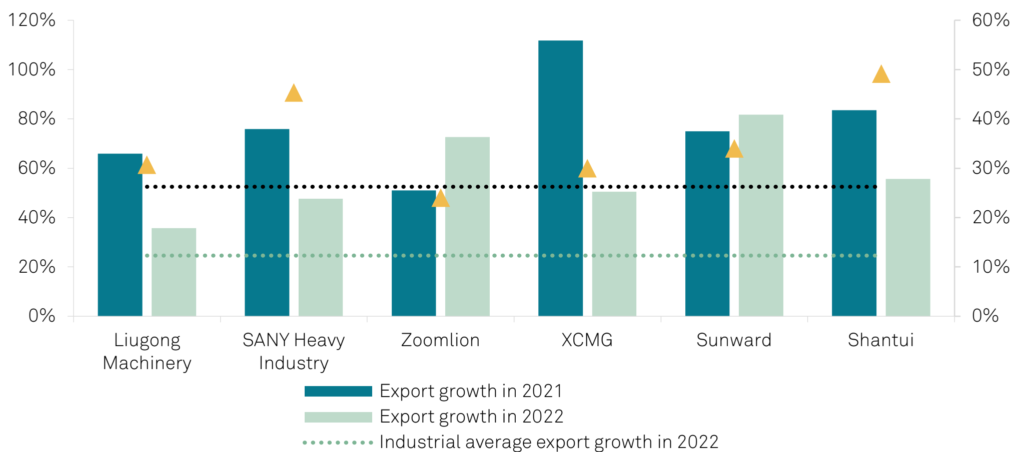
We also notice that most sampled entities demonstrate healthier liquidity profiles compared to their performance during the last round of down cycle, mainly because that:

1. Their exports are better than the industry average this time around, effectively offsetting the impact from the sluggish domestic sales. These leading companies leverage their stronger R&D and sales capabilities to build more competitive advantages in the export market. Noteworthily, construction machinery exports normally deliver higher gross margins, and thus the sound performance of most leading manufacturers in overseas markets has comfortably counterbalanced the decline in domestic sales.

Chart 10



Note: data of Liugong Group, SANY Group, Xugong Group are their listed subsidiaries' data due to data availability restriction.
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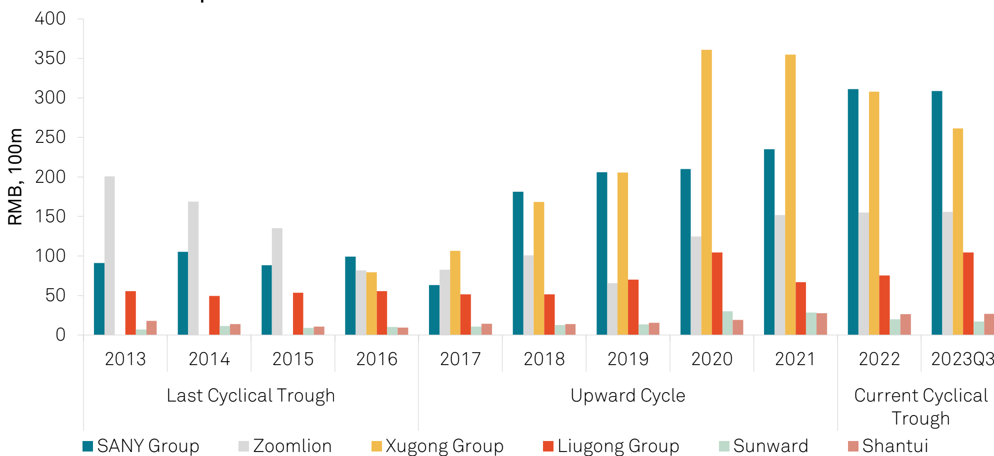
2. Construction machinery companies stocked up adequate cash during the expansionary cycle from 2017 through 2021, strengthening their liquidity sources.

Chart 11



Note: 2013 to 2015 data of Xugong Group undisclosed.
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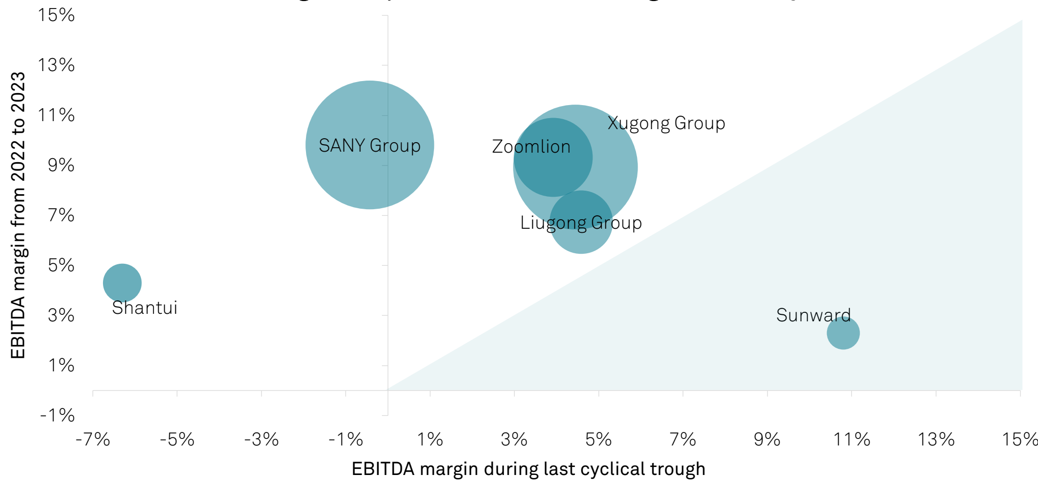
3. Most sampled companies post more stable earnings during the current down cycle. In the last round of downturn, these companies failed to lower the administrative and sales expense ratios amid sales slump, resulting in negative EBITDA and funds from operations for certain entities. Consistent cash outflows pose considerable liquidity pressure on these companies in the past. In contrast, SANY Group exhibits stronger abilities to manage cost and administrative and sales expenses during the current cyclical trough, posting more stable margins compared to the records during the previous cycle. The average EBITDA margin for the five entities stayed around 7-8% from 2022 through 2023, adding to their sources of liquidity.

Chart 12



Note: 1. All data adjusted by S&P Global (China) Ratings or S&P Global Ratings. 2. Bubble size represents revenue scale in 2022. 3. Xugong Group's data during last cyclical trough substituted by XCMG's data due to data availability restriction.
Source: public information, S&P Global (China) Ratings, CIQ.
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Appendix: List of Sampled Entities

Company Name	Abbreviation
Guangxi LiuGong Group Co., Ltd.	Liugong Group
SANY Group Co., Ltd.	SANY Group
Zoomlion Heavy Industry Science & Technology Co., Ltd.	Zoomlion
Xuzhou Construction Machinery Group Co., Ltd.	Xugong Group
Sunward Intelligent Equipment Co., Ltd.	Sunward
Shantui Construction Machinery Co., Ltd.	Shantui
SANY Heavy Industry Co., Ltd.	SANY Heavy Industry
XCMG Construction Machinery Co., Ltd.	XCMG
Guangxi Liugong Machinery Co., Ltd.	Liugong Machinery
Komatsu Ltd.	Komatsu
Caterpillar Inc.	Caterpillar
Deere & Co.	Deere

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