Mid-Year Review on Chinese LGFVs: Proactive Policies Mitigate Impact of the Economic Slowdown and COVID-19 Outbreak

Overview of Chinese LGFV Offshore USD Bond Issuance

The total issuance amount of Chinese LGFV offshore USD bonds recorded about a 45.5% decrease to USD7.8 billion and the number of issuance decreased by 20.8% to 42 in the first half of 2020, compared with the first half of 2019. 3-5 years remained the primary tenors. Bonds with maturity of below 3 years and of 3-5 years accounted for 16.0% and 76.2% of the total issuance amount in 1H 2020, respectively. Bonds with maturity of 5 years or more represented 7.7% of the total issuance amount in 1H 2020, compared with 9.3% in 2H 2019.

We see the trend of lower financing cost for Chinese LGFVs in 1H 2020. 41.9% of the bonds carried coupon rates of 4%-6% in 1H 2020, followed by the bonds with coupon rates of 2%-4% which accounted for 39.8% of the total issuance amount with 10.6 percentage points increase vis-à-vis 2H 2019. In addition, the Chinese LGFV offshore USD bonds market has not reported any default so far this year despite the abnormally tight liquidity worldwide.

Exhibit 1: Bond Issuance Amount and Number of Issuance

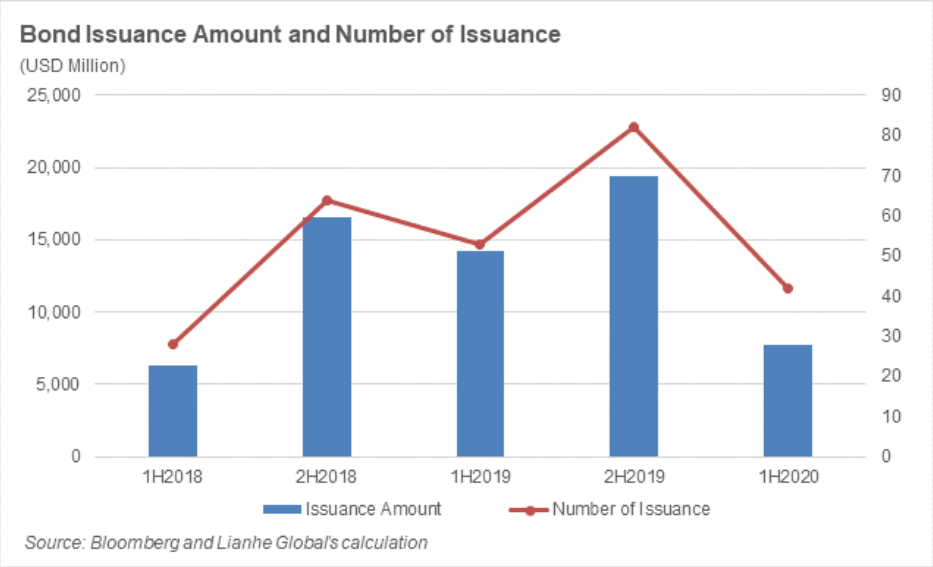


Exhibit 2: Breakdown of Bonds Issued by Maturity

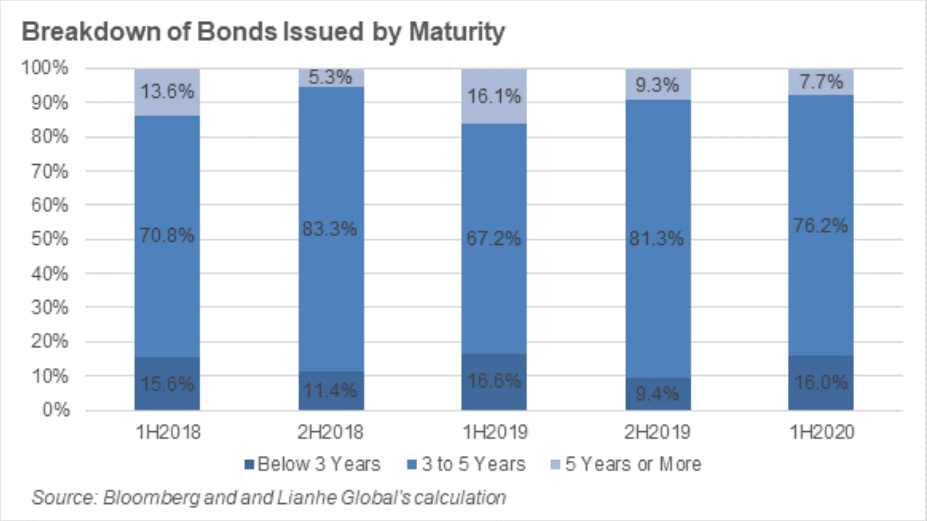
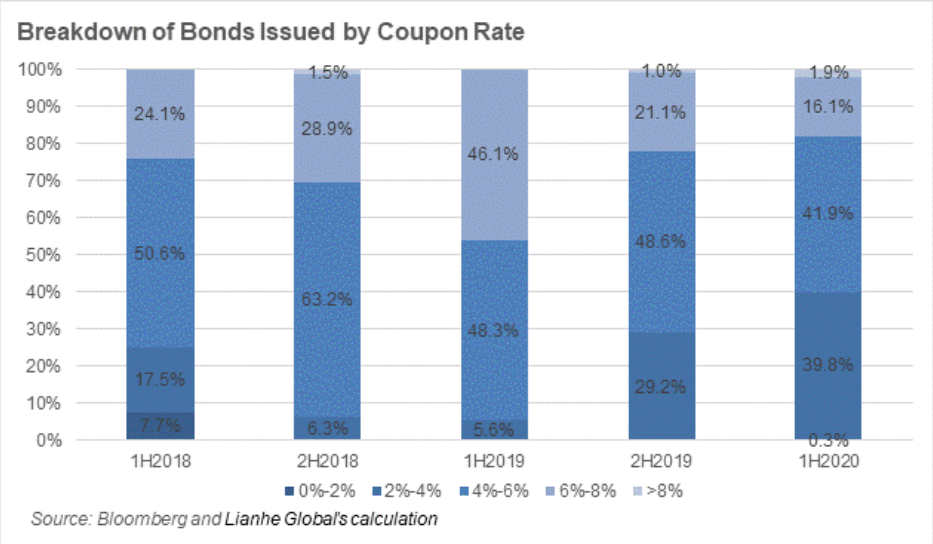


Exhibit 3: Breakdown of Bonds Issued by Coupon Rate



First Time Economic Contraction Since 1976

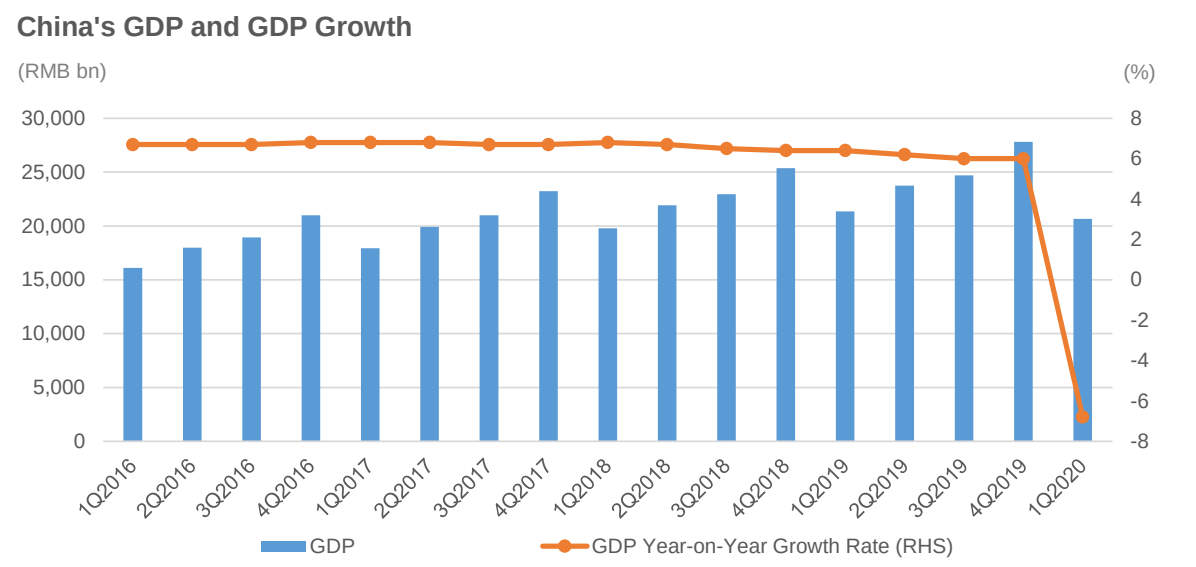
In the context of economic structural adjustment and the trade friction between China and the United States, China's economic growth has slowed in the recent years. Since around the beginning of 2020, China has encountered a new type of coronavirus pneumonia ("COVID-19") epidemic, with its first quarter GDP contracted by 6.8% in 1Q 2020 compared with the same period last year. This is China's first-time economic contraction since 1976. The GDP plunge has driven the shift of policymakers' priorities to ease monetary and fiscal policies. We foresee that the government will pursue greater public sector spending, particularly infrastructure investment, to underpin China's economic growth in 2H 2020 and 2021, which will be largely carried out by LGFVs.

Some provinces in the coastal areas still maintained strong economic growth, such as Fujian and Anhui, with year-on-year GDP growth rates of 7.6% and 7.5% in 2019, respectively. Guangdong, Jiangsu and Shandong were the three largest provinces, accounting for about 30% of China's total GDP in both 2018 and 2019. The northeast region (including Jilin,

Heilongjiang and Liaoning), which used to be China's heavy industry base, is experiencing difficulties in the process of economic transformation. These three provinces' GDP growth was weaker than the nationwide economic growth in 2018 and 2019. The growth rate of Heilongjiang and Jilin further slowed down in 2019 at 4.2% and 3.0%, respectively (2018: 4.7% and 4.5%), whereas Liaoning barely remained stable at 5.5% (2018: 5.7%).

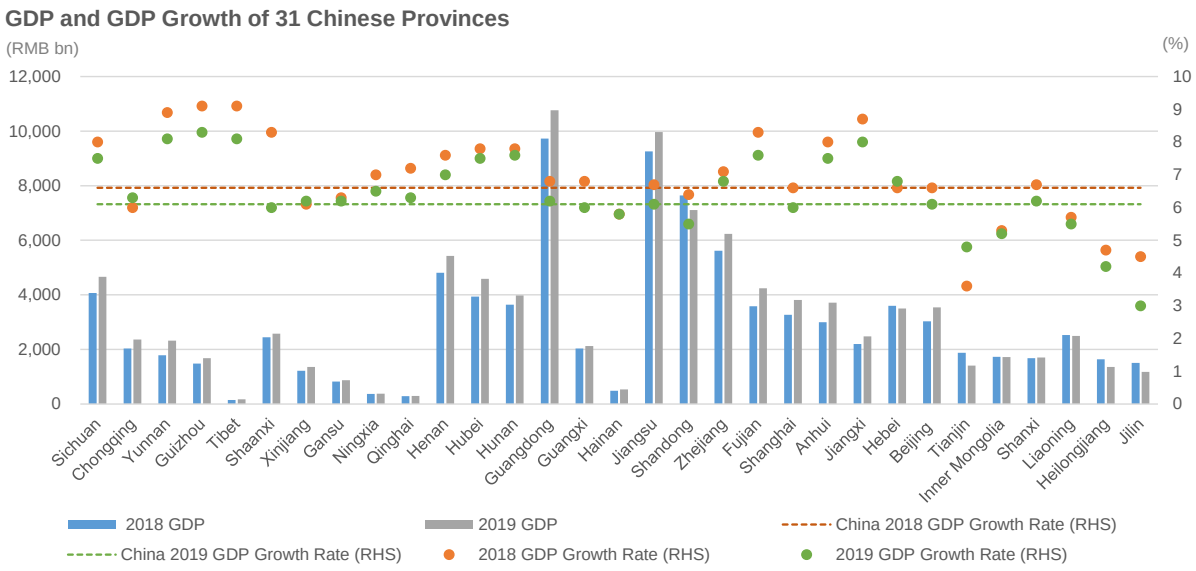
We expect that China's GDP growth rate in 2020 will decline significantly but still remain positive, due to the impact of the epidemic. Provinces with weaker economic structures, such as the Northeast region, may record a lower GDP growth rate. LGFVs located in these regions would encounter greater liquidity pressure as a result of their close relationships with their respective local governments in business and financial activities.

Exhibit 4: China's GDP and GDP Growth



Source: National Bureau of Statistics and Lianhe Global's calculation

Exhibit 5: GDP and GDP Growth of 31 Chinese Provinces



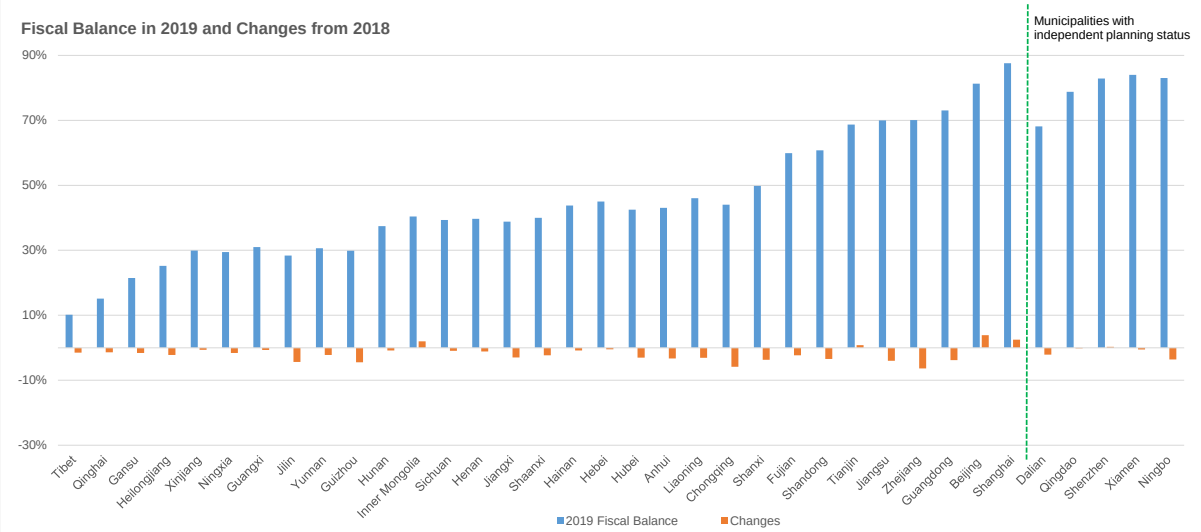
Source: National Bureau of Statistics and Lianhe Global's calculation

Rising Fiscal Pressure on Increasing Expenditure

Chinese local governments generally face fiscal deficits with the ratios of budgetary revenue to budgetary expenditure ("the fiscal balance ratio") falling in the range of 10% to 88% in 2019 for the 31 provinces. More than half of these local governments' fiscal deficits widened in 2019, although some governments have significant government fund income (mainly the revenue from land sales) or transfer payment to supplement their revenue. Less than one third of these local governments had a fiscal balance ratio of above 50% with Shanghai, Beijing and Guangdong ranking the top three (more than 73%), while Tibet, Qinghai and Gansu having the lowest of below 22% in 2019. The five municipalities with independent planning status, namely Dalian, Qingdao, Shenzhen, Xiamen and Ningbo, also maintained better fiscal condition with their fiscal balance ratios at above 68% in 2019.

The Chinese governments, particularly at the regional and local levels, would continue increasing debt financing in 2H 2020 due to greater fiscal pressure amid a slowing economy as well as expenditure for epidemic prevention and alleviation. A more proactive fiscal policy will accelerate the increase in fiscal expenditure, while the economic slowdown will pressure the growth in tax revenue and regulatory controls on the real estate sector will weigh on the revenue from land sales. In addition, China's local governments are taking more financing activities which were previously mainly conducted by LGFVs, aiming at improving transparency and supervision on their direct and contingent liabilities.

Exhibit 6: Fiscal Balance in 2019 and Changes from 2018



*Note: 1. Fiscal balance = budgetary revenue / budgetary expenditure*100%; 2. Changes = fiscal balance in 2019 - fiscal balance in 2018*
Source: Wind, local government finance bureau and Lianhe Global's calculation

Proactive Policies to Support the Real Economy and Financial Market Stability

Chinese regulators have adopted a series of proactive policies in response to the current challenging situation, mainly in the area of financing channels development and supervision and fund use guidance, aiming at supporting the fixed investment and real economy while maintaining the financial market stability.

In March and June 2020, CSRC[1] and NAFMII[2] removed the 40% maximum limit for bond issuers' outstanding bond balance to net assets ratio in the exchange and inter-bank bond markets successively. In addition, the central government has broadened the funding channels through the establishment of green channels for major projects, the creation of new types of corporate bonds, etc. In terms of the use of funds, the government focuses on the commencement and resumption of major investment projects to support the domestic demands, and direct funds to flow into those areas. At the same time, CBIRC[3] strengthened the supervision on financing through non-standard tools, such as trust funds, aiming to control unduly use of this channel for funding. We believe that the regulatory supervision will remain prudent in managing financial activities while ensuring adequate funding accessibility in certain industries to support economic activities.

[1] http://www.sse.com.cn/aboutus/mediacenter/hotandd/c/c_20200301_5001846.shtml
[2] http://www.nafmii.org.cn/ggtz/gg/202006/t20200612_80141.html
[3] https://www.cbirc.gov.cn/cn/view/pages/ItemDetail.html?docId=903052&itemId=951

Appendix: List of Lianhe Global Rated LGFV Entities

Issuer	Province/City	Issuer Rating/Outlook
Liangshan Development (Holdings) Group Co., Ltd	Liangshan	BBB-/Stable
Qingdao City Construction Investment (Group) Limited	Qingdao	A-/Stable
Yancheng Oriental Investment & Development Group Co., Ltd.	Yancheng	BB+/Stable
Zhengzhou Urban Construction Investment Group Co., Ltd.	Zhengzhou	A-/Stable

Source: Lianhe Global

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