

Investors' Top 10 Questions on Chinese LGFVs in the China Offshore USD Bond Market

Lianhe Ratings Global Limited (“Lianhe Global”) has been outreaching to both onshore and offshore investors in the past several months. Most investors are interested in the credit profiles of Chinese local governments and local government financing vehicles (“LGFVs”) in the China offshore USD bond market. We have summarized the most commonly-asked questions and our feedback in this report.

1. How does Lianhe Global define LGFVs and differentiate them with state-owned enterprises (“SOEs”)?

LGFVs are independent legal entities incorporated by local governments or other government departments. LGFVs originally function primarily as a platform to carry out various public policy missions and government development plans for the region’s economic development and social welfare, such as the construction of infrastructure projects in cities and rural areas, development of primary land, providing public goods and services as an extension of a local government, and management of state assets. Although an entity classified as an LGFV usually acts as an extension of government functions and is generally less profit-driven when compared with SOEs which are more market-oriented, the line of definition between LGFVs and SOEs has become less clear.

In the recent years, many LGFVs started shifting some business focus to various market-oriented activities such as materials sales or natural resources management, which we believe should be looked into on a case-by-case basis. If these businesses were upstream or downstream of the core policy-related business, or an extension of competitive positioning in terms of regional resources, willingness to support from the local government could still be deemed relatively probable. Having said that, the involvement of LGFVs in market-oriented activities has made it less straight-forward when analyzing whether an entity is fundamentally an LGFV or an SOE.

Besides ownership, Lianhe Global focuses on the following conditions when examining whether an entity should fall under the LGFV category: i) low or limited market-oriented business activities, ii) primary purposes are to provide public goods and services or manage state assets as an extension of government functions, iii) rely on some sort of government support, in forms such as subsidies or funding or capital/asset injections for operation and debt servicing, and iv) primary purposes are to provide commercial-related activities but government would normally provide necessary financial support to ensure operation sustainability. We examine closely whether the standalone business focus of an entity is in particularly non regional economic development strategy industries, which would make it more likely to fall under the category as an SOE.

Exhibit 1: Key Features of LGFVs and SOEs

	LGFVs	SOEs
Responsibility	Primarily act as an extension of government functions	Support important industries with national strategic importance for the economic development and social stability
Operation	Usually rely on earnings from profitable businesses and/or government subsidies to support daily operations	Market-oriented, responsible for their own profits and losses
Profit target	Not primarily profit focus but mainly to support local governments' policies and missions	Primarily profit focus to preserve and increase the value of state assets
Business	Land development, infrastructure construction, water, heating, public transportation, etc	Aerospace, shipping, military, petroleum, chemical engineering, heavy equipment and industrial machines, electronics, non-ferrous metals, etc
<i>Source: Lianhe Global</i>		

2. How are the roles of LGFVs evolving?

Given the central government's advocate for industry consolidation and resolving the risk arising from implicit debts, more LGFVs are involved in the consolidation in their region in order to improve their operating efficiency, control their debts and lower their financing costs. LGFVs with lesser role in core policy functions face higher risk of being consolidated. As mentioned before, we do examine closely on a case-by-case basis if an LGFV's businesses are evolving into more market-oriented activities.

Given the deteriorating sentiment in the Chinese property industry between the second half of 2021 and the first quarter of 2022, affecting sales performance, and the tight liquidity of Chinese property developers, participation in the land auctions by these property developers are dwindling, as shown in the second and third rounds of centralized land supply in 2021. As a result, more LGFVs are involved in the land auctions to support the land sales in their own local property markets. A number of those regions where participation from LGFVs were relatively high were regions with more stable property market and government fundamentals, such as Guangzhou, Shanghai, Wuxi, Suzhou and Nanjing. LGFVs from regions with less sound economic, fiscal or property market fundamentals who participated in the land auctions should be looked into more closely and carefully, given the relatively lower ability to support from the local governments.

3. How does Lianhe Global decide to adopt the top-down or bottom-up approach in assessing the credit profiles of LGFVs?

We incorporate the likelihood and degree of local government support into an LGFV's credit rating by using either a top-down or bottom-up notching approach. The policy role and strategic importance of an LGFV for a local government and local economy and the inter-relationship between the LGFV and the local government, including but not limited to ownership and control, are main considerations when we decide which approach to adopt.

In most cases, we choose the top-down approach for the sole or largest LGFV (which is significantly larger than the second one and hardly replaceable) within a jurisdiction as the probability of the LGFV receiving support from its associated local government is high. The LGFV usually has advantages in various aspects such as accessing to major government projects and receiving large asset transfers from the government or other LGFVs and significant financial subsidies. In addition, top-down approach would normally be applied for LGFVs with clear government functions and linkage.

As a local government's credit strength and its willingness to support affect the likely support for an LGFV, we use our internal credit assessment on a local government as an anchor and an LGFV's credit rating would be notched down from the anchor if we apply a top-down approach for the LGFV. On the other hand, we use an LGFV's standalone credit rating as an anchor and notch up from the rating to derive an LGFV's credit rating when the bottom-up approach is applied.

Lianhe Global may change the notching approach for an LGFV from the top-down to bottom-up, or vice versa, depending on the LGFV's business development and its relationship with the associated government. The top-down approach may become not applicable if there is perceived weakening in government support which could be due to reduced strategic importance of an LGFV with diminished government functions and/or a reduction of the state ownership. Conversely, a broader policy role or increased state shareholding could lead to a move from the bottom-up approach to top-down.

4. How does Lianhe Global assess the willingness to support of a local government?

Lianhe Global assesses a local government's willingness to provide support to its underlying LGFV primarily based on the analysis of four key factors: i) strategic importance, ii) potential impact of default, iii) ownership and control, and iv) operational and financial support.

Among these four factors, we consider that strategic importance and potential impact of default would generally have a higher influence on a local government's willingness to support an LGFV than the other two factors. This reflects our view that a local government would have a strong incentive to avoid adverse consequences from the failure of an LGFV especially for the prevention of major disruption to the local economy and social stability as well as the borrowing capacity of the local government and other LGFVs. A local government is also willing to support LGFVs who carry out core strategic government policies.

We assess the ability to support of a local government by looking at its credit profiles primarily in terms of soundness of economic and fiscal fundamentals.

5. How does Lianhe Global assess the ability to support of a local government?

The support ability of a local government to an LGFV within a jurisdiction is primarily based on the government's creditworthiness which is mainly underpinned by its economic, fiscal and monetary fundamentals, and is usually associated with the performance of the local economy and its administrative level. The level of the local economic activity and development impacts the jurisdiction's GDP, GDP growth prospects and a local government's fiscal revenue.

In general, the higher the level of a local government the LGFV is directly associated with, the higher the creditworthiness of the subject entity and the stronger the expected level of support from the local government.

We expect regional credit polarization to continue widening. Regions with high leverage and mediocre economic fundamentals, and higher exposure to implicit debt, such as Guizhou, Gansu, etc will continue to face financing pressure. In addition, government fund income of local governments were hard hit by declining land sales performance. Regions with high proportion of and declining income from government fund income, such as Shanxi, Hainan, Chongqing, etc will also continue to face financing pressure.

6. What are the major areas Lianhe Global focuses on when assessing credit profile of a local government?

We compare the economic and fiscal metrics, debt, leverage, administrative level etc, in order to assess and compare the credit qualities of local governments.

We assess the local economy primarily by its GDP size, GDP growth rate, GDP per capita and composition of its GDP. Generally, we favor an economy with high degrees of manufacturing and service industries, as we believe they are likely to provide a more sustainable economic growth momentum. Also, we examine a local government's geographic location and infrastructure, availability of and accessibility to natural resources, as well as human capital and demographics. Furthermore, we recognize the role of the central government's policies in a local economy.

A local government generally relies on three fiscal revenue sources: local tax revenue, government fund (primarily consists of land sale revenue), and transfer payments from central and/or higher-level governments. We examine fiscal revenue of a local government in terms of revenue structure, growth and stability. Generally, we favor a diverse and broad tax revenue base. We also favor a higher degree of flexibility and scalability on fiscal expenditure which is conducive to debt service in times of financial difficulties.

We examine the structure of a local government debt in the context of its debt ceiling, headroom, yield spread, debt and liability ratios. We examine the level of debt burden of a local government in proportion to its local economic strength and fiscal strength to understand the leverage level and associated financial risks and financial flexibility of the local government. We also look at utilization of debt quota, and the level of implicit debt as broadly classified as debt outstanding of all the LGFVs in the region.

7. How does Lianhe Global assess the standalone credit profiles of LGFVs?

We apply both business and financial analysis in assessing the credit profiles of LGFVs. Unlike those for-profit corporate companies, we apply an additional set of metrics such as nature of the business, development trends, scope and mode of operation, source of funding, efficiency of operating and asset management, project construction phase/cycle, method and stage of payment, and project under planning etc, for our business analysis. On the other hand, we assess LGFVs' asset quality, balance sheet structure, profitability, liquidity, repayment capacity and availability of credit facilities for the financial analysis.

In particular, we pay close attention to LGFVs' receivables. LGFVs with sizeable account of receivables and other receivables (particularly those that are current account receivables) may pose risks to its liquidity position. We examine its receivables exposure to key clients in this regard, including terms, aging and settlement trends. Also, we assess the collection rate of the receivables by paying close attention to the cash amount received comparing to the revenue.

Also, we pay close attention if LGFVs have a large amount of contingent liabilities and/or third-party guarantees. We will examine the commercial terms of these guarantees and their associated liens and claims against on the third party (or the related party) for its own benefits in case of a default. Exposure to and maturity profile of non-traditional financings are also a key area of focus when we assess the liquidity position of an LGFV.

All in all, the assessment of the standalone credit profile of an LGFV serves as an indication on the type of business that an LGFV is in and the underlying financial soundness of its businesses, which would affect whether and how the local government may extend support, as well as the local government's willingness to maintaining a linkage with the LGFV.

8. What is Lianhe Global's view on the LGFV offshore bond issuance and the credit trend in 2022?

We expect LGFVs offshore bond issuance will remain steady in 2022, mainly driven by the refinancing demand for their maturing bonds. Given the divergence in fiscal conditions and economic profiles across provinces and regions, we believe the credit polarization among LGFVs will continue in 2022. We are cautious on cities and regions with weak economic profiles, heavy local governments' debts, implicit debts and negative net financing amounts, particularly some individual provinces in the northwestern and southwestern regions.

LGFVs in regions with weaker economic and fiscal conditions will face more challenges in terms of financing and cash flow sustainability. We are also concerned about the credit risk of LGFVs with heightened short-term liquidity crunch and high proportions of non-standard and/or bond financing.

As mentioned before, given the central government's initiative to differentiate state support given to LGFVs and resolve the risk arising from implicit debts, we believe the industry consolidation will continue and accelerate. LGFVs with lesser roles in core policy functions, lower visibility of government support and under sponsor governments at lower administrative levels face higher refinancing hurdles and are under higher risk of being consolidated.

Moreover, the deteriorating contracted sales in the Chinese property industry, along with the nationwide implementation of the centralized land sales revenue collection starting from 2022, may weaken local governments' fiscal revenue and flexibility in their fiscal conditions.

9. What is the implication of the increase in transfer payments from the central government in 2022?

The central government announced to increase the transfer payments to local governments by RMB1.5 trillion, or 18% year-on-year, to RMB9.8 trillion in 2022. Also, local governments

are granted a quota of RMB3.65 trillion of special purpose bond issuance in 2022, which is roughly the same as 2021. RMB1.45 trillion has already been allocated in advance at end-2021 to boost investment and stabilize the economy. The Ministry of Finance has also published guidance on a number of principles when allowing a slight change in the use of proceeds from special purpose bond issuance for local governments.

We believe the increase in transfer payments shows a more obvious support willingness to local governments who carry out government mandates smoothly and with strategic importance in supporting the economy. It strengthens the fiscal conditions of local governments and mitigates the pressure from the expected decrease in land sales revenue in 2022. Also, the increase in transfer payments will strengthen the capacity of the local governments to implement stimulus in boosting their own local economies, such as tax cut and relief.

10. What is the trend in terms of offering structures for LGFVs offshore USD issuance?

Some LGFVs with weaker credit profiles employ the standby letters of credit (SBLC) in their offshore bond issuance. The SBLC is a guarantee from banks. In the event of bond default, the guarantors, which usually are commercial banks, are obligated for the repayment. Bonds backed by SBLC enhance their attractiveness to bondholders given the guarantee provided by banks. Having said that, even though the SBLC provider may be rated, the offshore USD bond issuance itself may still be unrated. Also, some LGFVs with weaker credit profiles may issue unrated bonds, which are commonly defined as neither the issuer nor the bond has a credit rating.

Appendix

List of Lianhe Global's Rated LGFVs

Issuer Name	Province/City	Issuer Rating /Outlook
Chengdu Airport Xingcheng Investment Group Co., Ltd.	Chengdu	BBB/Positive
Chengdu Dujiangyan Investment Development Group Co., Ltd	Chengdu	BBB-/Stable
Chengdu Wenjiang Xingrongxi City Operation Group Co., Ltd.	Chengdu	BBB-/Stable
Dalian Deta Holding Co., Ltd.	Dalian	BBB+/Stable
Liangshan Development (Holdings) Group Co., Ltd	Liangshan	BBB-/Stable
Qingdao City Construction Investment (Group) Limited	Qingdao	A/Stable
Shaoxing City Investment Group Limited	Shaoxing	A-/Stable
Shuifa Group Co., Ltd.	Shandong	A/Stable
Taizhou Hailing City Development Group Co., Ltd.	Taizhou	BBB-/Stable
Taizhou Huaxin Pharmaceutical Investment Co., Ltd.	Taizhou	BBB-/Stable
Wuxi Construction and Development Investment Corporation Limited	Wuxi	A/Stable
Yancheng High-tech Zone Investment Group Corporation Limited	Yancheng	BBB-/Positive
Yancheng Oriental Investment & Development Group Co., Ltd.	Yancheng	BB+/Stable
Yangzhou Economic and Technological Development Zone Development (Group) Co., Ltd	Yangzhou	BBB+/Stable
Zhengzhou Urban Construction Investment Group Co., Ltd.	Zhengzhou	A-/Stable
<i>Source: Lianhe Global</i>		

List of Lianhe Global's Rated LGFV Issuances

Issuer/Obligor Name	Date	Long-term Issuance Credit Rating
Liangshan Development (Holdings) Group Co., Ltd	2019-06-20	BBB-
Qingdao City Construction Investment (Group) Limited	2019-09-13	A-
Yancheng Oriental Investment & Development Group Co., Ltd.	2019-09-18	BB+
Zhengzhou Urban Construction Investment Group Co., Ltd.	2019-10-30	A-
Qingdao City Construction Investment (Group) Limited	2019-11-01	A-
Yancheng Oriental Investment & Development Group Co., Ltd.	2019-11-14	BB+
Zhengzhou Urban Construction Investment Group Co., Ltd.	2020-01-09	A-
Qingdao City Construction Investment (Group) Limited	2020-04-21	A-
Shaoxing City Investment Group Limited	2021-08-11	A-
Yangzhou Economic and Technological Development Zone Development (Group) Co., Ltd	2022-04-06	BBB+
<i>Source: Lianhe Global</i>		

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