

Shandong Hejian State-owned Capital Investment Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BBB
Outlook	Stable
Location	China
Industry	Local Government
	Financing Vehicle
Date	24 October 2022

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned ‘BBB’ global scale Long-term Issuer Credit Rating with Stable Outlook to Shandong Hejian State-owned Capital Investment Co., Ltd. (“SHSCI” or “the company”).

Summary

The Issuer Credit Rating reflects a high possibility that the Heze Municipal People's Government (“Heze government”) would provide strong support to SHSCI if needed, in light of its full ownership of SHSCI, SHSCI's strategic position as the major LGFV that is responsible for infrastructure construction, resettlement housing construction and land development in Heze, its important status as the sole state-owned asset operation entity in the region, and the strong linkage between the Heze government and SHSCI, including control and supervision over SHSCI's management, strategic alignment and ongoing operational and financial support. In addition, the Heze government may face significant negative impact on its reputation, business, and financing activities should SHSCI encounter any operational or financial difficulties.

The Stable Outlook reflects our expectation that SHSCI's strategic importance would remain intact while the Heze government will continue to ensure SHSCI's stable operation.

Rating Rationale

Heze Government's Full Ownership: The Heze government has 100% ownership of SHSCI via the State-owned Assets Supervision and Administration Commission of the Heze government (“Heze SASAC”). SHSCI was established with an initial registered capital of RMB500 million in 2019. After several capital injections and equity transfers, the registered capital and paid-in capital of SHSCI was enlarged to RMB5 billion and RMB4 billion, respectively at end-June 2022.

High Strategic Importance to Heze: As the second largest LGFV in terms of asset size in Heze at end-June 2022, SHSCI is responsible for infrastructures construction, resettlement housing construction, as well as land development and consolidation to promote the urban upgrading and economic development of Heze. As the only entity that undertakes the responsibility to operate state-owned asset in Heze, SHSCI's land development function and its role in rural construction have been further enhanced with the sizeable land use right injection in the first half of 2022.

Government Supervision and Strategic Alignment: The Heze government has strong control and supervision over SHSCI, including control of the board of directors, management supervision, decision on its strategic development and investment plan, supervision of its major funding decisions and daily operation. In addition, the Heze government has assessment mechanism over SHSCI and it appoints auditor to supervise the operating performance and financials on a periodic basis. SHSCI's strategic planning and development have been aligned with the local government's economic and social policies.

Ongoing Government Support: SHSCI received strong support from the government such as government subsidies, equity/asset injections and other financial supports. The Heze government repurchased some infrastructure projects and resettlement housing projects

Key Figures of Heze and SHSCI

(RMB billion)	2020	2021
Heze		
GDP	348	398
GDP growth rate (%)	3.9	8.8
Budgetary revenue	23.8	28.4
Government fund	44.8	47.2
Transfer payment	40.7	36.8
Budgetary expenditure	63.0	63.3
SHSCI		
Assets	18.5	21.0
Equity	11.8	12.3
Revenue	9.7	9.7

Source: Heze Municipal People's Government, Finance Bureau of Heze, SHSCI, and Lianhe Global's calculations

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Applicable Criteria

China Local Government Financing
 Vehicle Criteria (31 December 2021)

upon completion and provided policy supports to SHSCI to ensure its business operation. SHSCI has also received several equity transfers and asset injections from the Heze government, including some fixed assets and land use rights. Lianhe Global believes SHSCI is likely going to receive timely government supports in the form of operational and/or financial subsidies, as well as ongoing capital/equity injections to reinforce its function as the only state-owned asset operation LGFV in the region.

Moderate Financials with Sufficient Liquidity: SHSCI had a total asset of RMB42.3 billion at end-June 2022. Its financial leverage as measured by total liabilities/total assets increased from 36.3% at end-2020 to 41.3% at end-2021, but dropped significantly to 23.6% at end-June 2022, mainly due to the substantial increase in the total assets after the injection of intangible and fixed assets. SHSCI relied on borrowings to fund its capital expenditure. Its total adjusted debt increased from RMB4.4 billion at end-2021 to RMB6.3 billion at end-June 2022. The liquidity of SHSCI was sufficient as it had a cash balance of approximately RMB3.2 billion and unused credit facilities of RMB25.8 million, compared with debt due within one year of c. RMB1.3 billion at end-June 2022. SHSCI has access to various financing channels, including bank loans and bond issuances etc., to support its debt repayment and business operation.

Moderate Economic and Fiscal Strength of Heze: In 2021, Heze realized RMB397.7 billion GDP, representing a year-over-year growth rate of 8.8%, which was higher than that in 2018 and 2019 (7.9% and 6.3%). Heze's economic growth was mainly fueled by the secondary and tertiary industries, accounting for 41.6% and 48.6% of its total GDP, respectively in 2021. Heze's budgetary revenue growth slowed in 2020 but bounced back in 2021, with a growth rate of 3.9% and 8.8%, respectively. The tax revenue as a percentage of budgetary revenue has stood at around 75-80% level since 2018. Heze's government debt and budget deficit were relatively high. Its government debt increased to RMB110.8 billion at end-2021 from RMB86.8 billion at end-2020, representing year-over-year growth of 27.6%, while the budget deficit has exceeded 100% for three straight years since 2019. Its fiscal debt ratio (total government debt outstanding/aggregate revenue) stayed at a high level of 98.1% at end-2021.

Rating Sensitivities

We would consider downgrading SHSCI's rating if (1) there is perceived weakening in support from the Heze government, particularly due to its reduced strategic importance with diminished government functions, or (2) there is a significant reduction in the Heze government's ownership of SHSCI, or (3) there is a downgrade in our internal credit assessment on the Heze government.

We would consider upgrading SHSCI's rating if (1) there is strengthened support from the Heze government, or (2) there is an upgrade in our internal credit assessment on the Heze government.

Operating Environment

Moderate Economy with Stable Growth of Heze City

Heze realized a GDP of RMB397.7 billion in 2021, representing a year-on-year growth of 8.8%. The growth rate was higher than the pre-COVID years of 2018 and 2019 (7.9% and 6.3%, respectively). To eliminate the low base effect of 2020, Lianhe Global uses Heze's compound annual growth rate ("CAGR") of GDP from 2019 to 2021, which was 8.0%, as a comparison. It was higher than the CAGR of the GDP of China (7.7%) and comparable to

that of Shandong Province (8.3%) over the same period. Heze's economic growth was mainly fueled by the secondary and tertiary industries, accounting for 41.6% and 48.6% of its total GDP respectively, in 2021.

Despite the relatively high growth rate, Heze's absolute amount of GDP was still low. It was ranked 8th in Shandong Province at end-2021 (out of the 16 prefecture-level cities). At the same time, Heze's GDP per capita was RMB45,539, which was ranked 15th in Shandong Province and it was well below the province's average of RMB81,747.

Heze's GDP and Fixed Asset Investment			
(RMB billion)	2019	2020	2021
GDP	341.0	348.3	397.7
-Primary industry (%)	9.7	9.9	9.8
-Secondary industry (%)	44.4	40.2	41.6
-Tertiary industry (%)	45.9	49.9	48.6
GDP growth rate (%)	6.3	3.9	8.8
Fixed asset investment	154.5	166.1	192.4
Fixed asset investment growth rate (%)	8.1	7.5	15.8
Population (million)	8.8	8.8	8.7

Source: Statistical Bureau of Heze and Lianhe Global's calculation

Fiscal Conditions of Heze

Heze's budgetary revenue growth slowed in 2020 but bounced back in 2021, with a growth rate of 3.9% and 8.8%, respectively. The tax revenue as a percentage of its budgetary revenue has stood at around 77-80% level since 2018, except in 2020 (75.2%). The anomaly in 2020 was caused by various government policies in response to the COVID-19 pandemic, including tax and fee cuts, etc.

Heze's government debt and budget deficit were high. Its government debt increased to RMB110.8 billion at end-2021 from RMB86.8 billion at end-2020, representing year-on-year growth of 27.6%, while the budget deficit has exceeded 100% for three straight years since 2018. It is noteworthy to mention that the Heze government's fiscal debt ratio (total government debt outstanding/aggregate revenue) had increased significantly from 34.5% to 98.1% from 2018 to 2021, which was mainly due to the significant increase in its special purpose debt.

Heze's Fiscal Conditions			
(RMB billion)	2019	2020	2021
Budgetary revenue	22.2	23.8	28.4
Budgetary revenue growth rate (%)	7.7	7.2	19.3
Tax revenue	17.5	17.9	21.9
Tax revenue (% of budgetary revenue)	78.8	75.2	77.0
Government fund income	37.9	44.8	47.2
Transfer payment	38.6	40.7	36.8
Aggregate revenue	99.3	109.5	112.9
Budgetary expenditure	61.9	63.0	63.3
Budget deficit ¹ (%)	-178.9	-165.0	-122.9

¹ Budget deficit = (1 - budgetary expenditure / budgetary revenue) * 100%

Source: Finance Bureau of Heze and Lianhe Global's calculations

Ownership Structure and Profile

Full State Ownership with Strong Government Supervision

SHSCI was established in 2019 as Shandong Hejian Construction Group Co., by the State-owned Assets Supervision and Administration Commission of the Heze government (“Heze SASAC”), with a registered capital of RMB500 million in the form of equity contribution at the time of establishment. In December 2019, by the decree of the Heze SASAC, the registered capital was expanded to RMB5 billion, while the method of capital contribution was changed to payment and equity contribution. There has been no change in the registered capital and shareholding structure of SHSCI since then, the Heze SASAC is the controlling shareholder and the actual controller. The paid-in capital of SHSCI was RMB4 billion at end-June 2022.

SHSCI is the only state-owned asset operation entity in Heze, and the Heze government has strong supervision over SHSCI including control of the board of directors, management supervision, strategic alignment, investment and financing strategies.

Strategic Importance and Government Linkage

Strategic Importance of SHSCI to Heze

As the second largest and the major LGFV in Heze, SHSCI is responsible for infrastructure construction, as well as resettlement housing construction and land development and consolidation to promote the urban upgrading of Heze. As the only entity that undertakes the responsibility to operate state-owned asset in Heze, SHSCI’s land development function and its role in rural construction has been further enhanced and improved with the large land use right injection in the first half of 2022. SHSCI’s strategic planning and development has been aligned with the local government’s economic and social policies. It carries out the directions and policies of urban development by the Heze government to support the local economy growth.

Strong Linkage with the Heze Government

SHSCI’s linkage with the local government is strong as it is wholly owned by the Heze government through the Heze SASAC.

The Heze government has strong control and supervision over SHSCI, including control of the board of directors, management supervision, decision on its strategic development and investment plan, supervision of its major funding decisions and daily operation. In addition, the Heze government has assessment mechanism over the company and it appoints auditor to supervise the operating performance and financials on a periodic basis.

Ongoing Government Support

SHSCI received supports from the local government, which are not limited to capital injections, equity transfers, government subsidies, tax deduction and policies support in its daily management. SHSCI received equities transferred from the Heze government in 2019 and 2020, including the equity of several property service companies and engineering construction companies in Heze, with a total book value of c. RMB484.6 million. The capital injection in 2019 mainly consisted of the net assets of Hejian, underground comprehensive pipe corridor and some greening engineering projects, while the injection in the first half of

2022 mainly included land use rights, which was earmarked to support SHSCI's land development and consolidation business. Per the Heze government, it will enlarge SHSCI's asset size continuously by ongoing capital and/or asset injection to reinforce its functions as the only state-owned asset operation LGFV in the region.

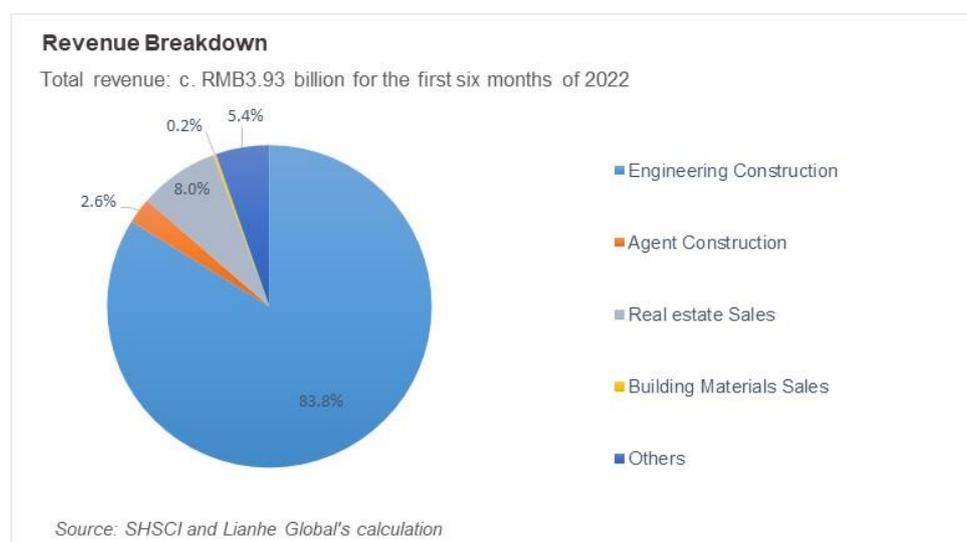
SHSCI continued to receive financial subsidies from the local government to maintain its business operation, including operational subsidies and policy supports, etc. SHSCI received subsidies of approximately RMB0.3 million, RMB175.2 million and RMB3.6 million in 2019, 2020 and 2021, respectively. Besides, SHSCI also received RMB38.4 million subsidies from the Heze government to guarantee the operation of related resettlement housing construction projects in the first half of 2022. The Heze government also repurchased some infrastructure projects and resettlement housing projects upon completion and provided policy supports to SHSCI to ensure its business operation. Given the strategic importance of SHSCI in land development and infrastructure related projects construction in the region, SHSCI and its subsidiaries have advantages to obtain land resources and main projects. Lianhe Global believes SHSCI is likely going to receive government supports in the form of operational and/or financial subsidies in the future.

Business Profile

The Major LGFV Responsible for Infrastructure Construction, Resettlement Housing and Land Consolidation in Heze

As the second largest and the major LGFV in Heze, SHSCI mainly integrates the functions of infrastructure construction, land development and state-owned asset operation to implement the related instructions of the Heze government realizing the overall urban upgrading. SHSIC mainly carries out these functions through itself and its subsidiaries, including engineering construction, agent construction, real estate sales and other businesses such as construction material sales and construction labor service, to actively participate in relevant major industrial transformation projects and public service projects in Heze and further drives the development of the regional economy.

The total revenue of the company remained relatively stable at approximately RMB9.7 billion in 2019-2021, and reached RMB3.9 billion for the first six months of 2022. The revenue generated from engineering construction, including municipal projects construction and housing construction, accounted for more than 80% of its total revenue. Thus, the performance of its total revenue's scale is highly correlated to this business segment, while the revenue recognition schedule of agent construction projects (all of which are resettlement housing construction) will depend on government's repayment schedules. The gross margin of SHSCI increased from c.11.8% in 2019-2021 to 13.5% for the first half of 2022, mainly due to the increased margin of real estate sales.



Agent Construction

SHSCI's revenue from agent construction segment was all generated from resettlement housing construction, which operated under self-construction and agency construction modes. For the agency construction mode, the company signs a resettlement housing construction and repurchase agreement with the local government. The repurchase price includes development costs plus a profit margin (usually c. 5%). The land cost of the project is borne by the local government, which is fully paid by the company in advance but will be reimbursed after the handover of the related projects. For the self-construction mode, SHSCI signs the resettlement housing sales contract with target groups (those who have right to purchase the resettlement houses) and sells the houses to them at the price agreed by the government upon completion.

The revenue from this business segment was RMB1.4 billion, RMB263.9 million and RMB101.0 million in 2020, 2021 and for the first six months of 2022 with a stable gross margin at c. 7.8% given the contracted additional margin and stable paybacks. SHSCI now has 6 agent construction projects under construction, of which 2 are in the agency construction mode, while 4 are in the self-construction mode, with a total proposed investment of RMB1.24 billion, putting pressure on its capital expenditure.

Land Development and Consolidation

According to the Heze government, SHSCI is the most important entity in the fields of land development and land consolidation in the region. SHSCI, as entrusted by the Heze government, carries out land development and consolidation projects alone or in cooperation with local governments in accordance with the general plan of the related departments. This segment is currently in the preliminary expansion stage with no income generated at end-June 2022.

The Gaozhuang Town Comprehensive Land Improvement Project, as the largest project in this segment with a total proposed investment of RMB6 billion and a construction period of 5 years, is well underway since coming to terms with the Heze government in 2019. The profit for this project shall be shared between SHSCI and the Heze government with a 50-50 ratio after deducting the related cost (including loan interest). Besides, SHSCI received c. RMB10.5 billion of land use right from the Heze government in the first half of 2022, which was injected for the purpose of expanding the scale of SHSCI's future land development and consolidation business, as well as supporting the urban development of the region.

Engineering Construction

Engineering construction, as the largest component of SHSCI's total revenue, is mainly operated by the main subsidiary of the company, Hejian. The segment is divided into municipal engineering construction projects and housing construction projects, of which the former accounting for c. 60-70% while the latter accounting for the rest c. 30%-40% based on the value of contracts signed in the past. Relying on its background as a state-owned entity, SHSCI has certain advantages in acquiring local municipal projects. In terms of projects locations, newly signed contracts were mainly concentrated in Heze, which accounted for 77.8% and 69.1% of total in terms of newly contracts' value in 2021 and for the first six months of 2022, respectively. For projects outside of Heze, they were widely distributed in cities across China such as Beijing, Xinjiang, Qingdao, etc.

The total revenue generated from this segment reached RMB8.3 billion, RMB7.2 billion, RMB7.9 billion and RMB3.3 billion in 2019, 2020, 2021 and for the first six months of 2022, respectively, with a stable gross margin at around 10%. The engineering construction projects are generally settled by stages according to the progress of the project. The cash collection period for the general municipal projects and housing construction is 2 years, while the former typically has a longer repayment period. For municipal engineering construction projects, SHSCI mainly undertakes relevant projects through open market bidding. At end 2021, SHSCI had completed 761 major municipal engineering projects with a total contract value of RMB25.4 billion and 563 housing construction projects with a total contract value of RMB15.9 billion.

Real Estate Sales

SHSCI's real estate sales business mainly includes residential real estate development and sales, located in Heze, Haikou (Hainan province) and other places. The revenue from this segment was RMB879.2 million, RMB654.0 million, RMB971.9 million and RMB313.9 million in 2019, 2020, 2021 and for the first six months of 2022. The gross margin, as affected by the current downturn of the real estate sector, faced a downward trend since 2021 and the first half of 2022. The average selling price of the SHSCI's contract sales was c. RMB11,972/square meter in the first half 2022, compared with c. RMB11,852/square meter in 2021. The Haijingwan project in Haikou is now the only project under construction in this segment, with a total building area of 10.6 million square meters and a total investment of c. RMB633 million. This segment also involves some government related property sales such as affordable housing and personnel housing. Overall, the demand for SHSCI's real estate sales was relatively strong and there were practically no unsold units in this segment.

Other Businesses

SHSCI's other businesses mainly include building materials sales, building services, property management, housing leasing and investment management, etc., most of which are ancillary service businesses aligned with its integral industrial chain. The other businesses have limited impact and contribution to SHSCI's total revenue due to their small business scales.

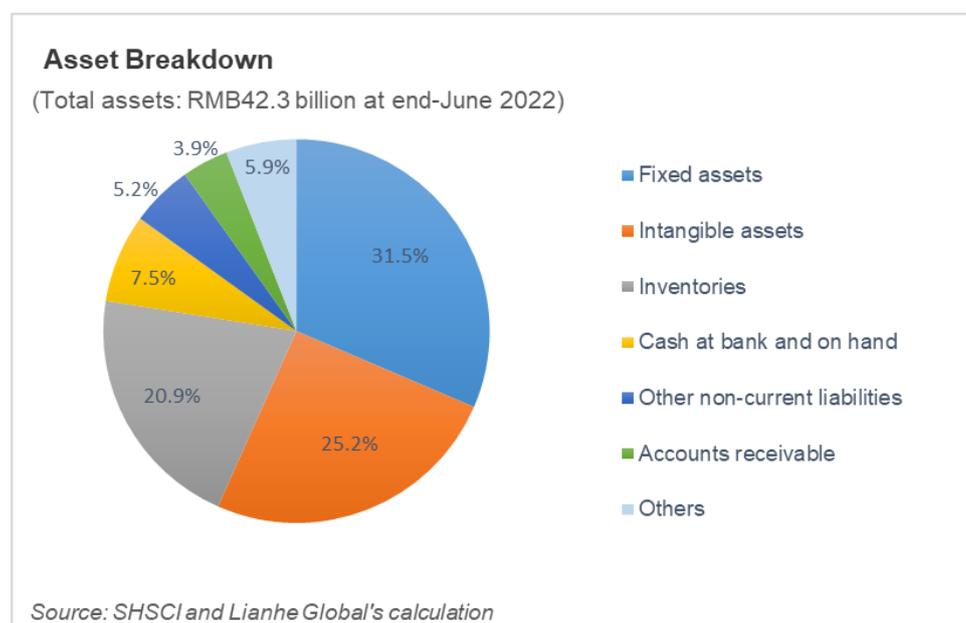
Financial Profile

Balance Sheet Structure and Quality

Balance Sheet Structure and Quality				
(RMB million)	2019	2020	2021	1H2022
Total Asset	20,047	18,496	21,001	42,327
Equity	10,980	11,777	12,331	32,357
Debt	1,628	1,754	4,368	6,310
Debt / (Debt + Equity) (%)	12.9	13.0	26.2	16.3
LT Debt	309	185	2,370	3,013
LT Debt / (LT Debt + Equity) (%)	2.7	1.5	16.1	8.5

Source: SHSCI's financial reports and Lianhe Global's calculations

SHSCI's total assets were relatively stable at around RMB20 billion during 2019 to 2021, but increased significantly to RMB42.3 billion at end-June 2022 due to the large injection of fixed assets (RMB7.0 billion) and intangible assets (RMB10.5 billion) from the Heze government, including tourist attractions, industrial parks, theme parks, irrigation systems and unused government properties. At end-June 2022, the asset structure also changed due to the aforementioned reasons. The fixed assets accounted for c. 32% of its total assets, the majority of which were buildings and structures (97.8%). The intangible asset's proportion to the total asset increased to 25.2% at end-June 2022 from 1.1% at end-2020, mainly including use right of land SHSCI acquired from the Heze government (99.5%). However, c. 98% of the intangible asset has not completed the title deed, where the proposed processing procedures would be completed at end-2023, per SHSCI's management. The inventory, as the third largest component, accounted for c. 21% of the total asset at end-June 2022, mainly including construction costs and projects under construction. The overall asset structure was aligned with SHSCI's business nature, where the engineering and agent construction made up the majority of its total revenue.



SHSCI relied on borrowings to fund its capital expenditure, and its short-term borrowings and debentures payables accounted for c. 40% of its total liabilities at end-June 2022. The total adjusted debt of SHSCI increased from RMB4.4 billion at end-2021 to RMB6.3 billion at end-June 2022, mainly due to the increase of short-term borrowings and notes payables.

The short-term and long-term adjusted debt accounted for 52.3% and 47.7% of its total adjusted debt respectively, at end-June 2022. SHSCI's financial leverage as measured by total liabilities/total assets increased from 36.3% at end-2020 to 41.3% at end-2021, but dropped significantly to 23.6% at end-June 2022, mainly due to the substantial increase in the total assets after the injection of intangible and fixed assets.

Cash Flow

Cash Flow (RMB million)	2019	2020	2021	6M2022
Cash Inflows from Operation	11,160	10,284	10,117	4,267
Cash Outflows from Operation	10,781	9,383	10,646	4,243
Net CF from Operation	379	901	-530	24
Cash Inflows from Investment	0	34	263	71
Cash Outflows from Investment	21	1,116	487	121
Net CF from Investment	-20	-1,082	-224	-49
Cash Inflows from Financing	2,121	3,038	5,254	3,062
Capital Contribution	1	6	0	0
Borrowings	808	865	3,445	1,625
Others	1,312	2,167	1,808	1,437
Cash Outflows from Financing	2,399	2,997	3,941	3,266
Net CF from Financing	-279	41	1,312	-204
Net Increase in Cash and cash equivalent	80	-140	559	-229

Source: SHSCI's financial reports

Debt Servicing Capability

The liquidity of SHSCI was sufficient. SHSCI had a cash balance of approximately RMB3.2 billion and unused credit facilities of RMB25.8 million at end-June 2022, compared with debt within one year of c. RMB1.3 billion at the same time. The majority of the bank loans were liquidity loans, which can be rolled over without credit cut given the good reputation and stable operating of SHSCI in the region, per SHSCI's management. Besides, SHSCI currently has a total onshore bond issuance quota of RMB6.5 billion, either available or under application. SHSCI has access to various financing channels including bank loans and bond issuance to support its debt repayment and business operation.

Debt Maturity Profile at end-June 2022 (RMB million)	Amount	Percentage
2H2022	802.6	18.6%
2023	641.7	14.8%
2024	466.8	10.8%
2025	86.1	2.0%
2026 and thereafter	2,330.1	53.8%
Total	4,327.4*	100.0%

Source: SHSCI and Lianhe Global's calculations

*Note: The discrepancy between the total debt in the 'Debt Maturity Profile' and 'Balance Sheet Structure and Quality' was caused by the inclusion of notes payable in the latter

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