

# Hubei Optics Valley East State-owned Capital Investment and Operation Group Co., Ltd.

## Initial Issuer Report

Summary	
Issuer Rating	BBB
Outlook	Stable
Location	China
Industry	Local Investment and Development Companies
Date	23 December 2022

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned ‘BBB’ global scale Long-term Issuer Credit Rating with Stable Outlook to Hubei Optics Valley East State-owned Capital Investment and Operation Group Co., Ltd. (“HOVE” or “the Company”)

### Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of Daye City (“the Daye government”) would provide strong support to HOVE if needed, in light of its full ownership of HOVE, HOVE’s strategic importance as the most important local investment and development company (“LIDC”) that is responsible for infrastructure construction, land consolidation and city operations in Daye, and the strong linkage between the Daye government and HOVE, including control of the board of directors, management supervision, strategic alignment, and ongoing operational and financial support. In addition, the Daye government may face significant negative impact on its reputation and financing activities should HOVE encounter any operational and financial difficulties.

The Stable Outlook reflects our expectation that HOVE’s strategic importance would remain intact while the Daye government will continue to ensure HOVE’s stable operation.

### Rating Rationale

**Government’s Ownership and Supervision:** The Daye government, the ultimate controller of HOVE, holds 100% equity of HOVE through the State-owned Assets Supervision and Administration Bureau of Daye (“Daye SASAB”). The Daye government supervises the company via Daye SASAB, including control of the board of directors, senior management appointment and decision-making on major investment and financing plans. In addition, the local government has set up an annual assessment mechanism for HOVE and regularly appoints auditors to review its operating performance and financial position.

**Strategic Importance and Strategic Alignment:** HOVE is the most important LIDC that is responsible for land consolidation and infrastructure construction in Daye. Its project scope mainly includes roads, drainage networks, settlement houses, industrial parks, schools and afforestation, etc. The company is also responsible for most land consolidation in Daye. In addition, the company participates in city operations, including water supply and sewage treatment, as well as public transportation. HOVE’s business operations and strategic planning have been aligned with the local government’s economic and social development policies.

**Ongoing Government Support:** HOVE received increasing financial subsidies from the Daye government in the past three years, amounting to RMB416 million, 587 million, 626 million and 539 million in 2019, 2020, 2021 and the first nine months of 2022, respectively. These subsidies were provided to support HOVE’s operations relating to delivering public goods and public services. We expect HOVE to enjoy ongoing financial subsidies in the future.

Key Figures of Daye and HOVE (RMB billion)		2020	2021
<b>Daye</b>			
GDP	64.7	75.1	
GDP growth rate (%)	-4.2	14.4	
Budgetary revenue	2.7	4.1	
Government fund	1.8	5.6	
Transfer payment	5.1	2.7	
Budgetary expenditure	8.6	7.9	
<b>HOVE</b>			
Assets	48.7	50.5	
Equity	25.7	26.3	
Revenue	1.2	1.7	

Source: Public Information, HOVE and Lianhe Global’s calculations

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### Applicable Criteria

China Local Investment and Development Companies (5 December 2022)

**Economy and Fiscal Conditions of Daye:** The pandemic of COVID-19 in 2020 led to widespread lockdown and production suspension in the whole Hubei Province, which had a significant negative impact on Daye's economy. In 2021, Daye's economy recovered quickly. Its GDP reached RMB75.1 billion, with a growth rate of 14.4%, while fixed asset investment grew by 30.7% year-on-year. Both budgetary revenue and government-managed fund income of the Daye government rebounded significantly in 2021, recording growth rates of 50.2% and 207.3%, respectively. However, we expect that such high growth rates are unlikely to sustain in the coming years.

The fiscal self-sufficiency rate of the Daye government was relatively low, especially in 2020. Yet its government debt was manageable in the past three years, despite the fact that the total outstanding government debt increased to c. RMB8.3 billion at end-2021 from c. RMB6.7 billion at end-2019. Daye's government debt ratios (i.e., total government debt divided by aggregate revenue) stayed at c. 66-68% level, except 75.7% in 2020.

**HOVE's Financial Matrix and Liquidity Position:** HOVE's financial leverage, as measured by total debts/capitalization was manageable, which was 47.1% at end-September 2022, while its total liabilities/total assets ratio was 53.2%. Yet the company's assets liquidity was weak, as its assets mainly consisted of inventories and construction in progress that could take a long time to monetize, as well as other receivables with an uncertain collection schedule.

At end-September 2022, HOVE had cash of RMB2.4 billion (including restricted cash of RMB1.7 billion), compared with its debts due within one year of RMB9.3 billion. Yet the company also had available bank credit lines of RMB14.2 billion. These could support HOVE's refinance and operations to some extent.

**Moderately High Contingent Liability Risk:** HOVE's contingent liability risk was moderately high. It provided financial guarantees of RMB6.6 billion to external parties at end-September 2022, representing 24.9% of the company's equity. That included financial guarantees to SOEs, local investment and development companies and public institutions collectively of c. RMB5.6 billion. The rest of RMB949 million was provided to privately or collectively owned companies, from which HOVE usually requires counter-guarantee measures.

## Rating Sensitivities

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

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

## Operating Environment

### Economic Condition of Daye

Daye is a county-level city neighboring Wuhan and directly under the jurisdiction of Hubei Province and administered by Huangshi City with a residential population of c. 0.9 million. Being famous for its mining and metallurgy industry, Daye is an important raw material industry base in China. Thus, the local economy was mainly driven by the secondary

industry, which accounted for 55.5% of GDP in 2021, followed by the tertiary industry (37.3%) and primary industry (7.3%).

The pandemic of COVID-19 in 2020 led to widespread lockdown and production suspension in the whole Hubei Province, which had a significant negative impact on Daye's economy, as shown in both the negative GDP growth rate and negative fixed asset investment growth rate in 2020. In 2021, Daye's economy recovered quickly. Its GDP reached RMB75.1 billion, with a growth rate of 14.4%, while fixed asset investment grew by 30.7% year-on-year.

Daye's GDP and Fixed Asset Investment (RMB billion)	2019	2020	2021
GDP	68.1	64.7	75.1
-Primary industry (%)	6.8	8.0	7.3
-Secondary industry (%)	60.5	58.6	55.5
-Tertiary industry (%)	32.7	33.5	37.3
GDP growth rate (%)	8.1	-4.2	14.4
Fixed asset investment	55.7	45.5	59.5
Fixed asset investment growth rate (%)	12.7	-18.3	30.7
Population (million)	0.8	0.9	0.9

*Source: Statistics Bureau of Daye and Lianhe Global's calculations*

## Fiscal Condition of Daye

The pandemic also exacerbated the slumps in both budgetary revenue and government-managed fund income of the Daye government in 2020, with growth rates of -37.2% and -15.9%, respectively. The higher-level governments enlarged their transfer payment to the Daye government in 2020 to neutralize the impact of the pandemic. As a result, its aggregate fiscal revenue remained stable in 2020.

In 2021, both budgetary revenue and government-managed fund income of the Daye government rebounded significantly, recording growth rates of 50.2% and 207.3%, respectively. However, we expect that such high growth rates are unlikely to sustain in the coming years.

The fiscal self-sufficiency rate of the Daye government was relatively low, especially in the year of pandemic. It recorded budget deficit of 89.6%, 219.8% and 95.2% in 2019, 2020 and 2021, respectively. Yet the government debt was manageable in the past three years, despite the fact that the total outstanding government debt increased to c. RMB8.3 billion from c. RMB6.7 billion at end-2019. Daye's government debt ratios (i.e., total government debt divided by aggregate revenue) stayed at c. 66-68% level, except 75.7% in 2020.

Daye's Fiscal Condition (RMB billion)	2019	2020	2021
Budgetary revenue	4.3	2.7	4.1
Budgetary revenue growth rate (%)	-4.5	-37.2	50.2
Tax revenue	3.1	1.9	3.0
Tax revenue (% of budgetary revenue)	71.3	71.2	74.8
Government fund income	2.2	1.8	5.6
Transfer payment	3.3	5.1	2.7
<b>Aggregate revenue</b>	<b>9.7</b>	<b>9.6</b>	<b>12.3</b>
Budgetary expenditure	8.2	8.6	7.9
<b>Budget deficit<sup>1</sup> (%)</b>	<b>-89.6</b>	<b>-219.8</b>	<b>-95.2</b>

<sup>1</sup> Budget deficit = (1-budgetary expenditure / budgetary revenue) \* 100%

*Source: Finance Bureau of Daye and Lianhe Global's calculations*

## Ownership Structure

### Government's Full Ownership

HOVE, formerly known as Daye State-Owned Assets Management Co., Ltd., was established in 2003 with initial registered capital of RMB30 million. The establishment was approved by the People's Government of Hubei Province and the Daye government. The company was the major state-owned assets operating entity in Daye. Its operation scope included state-owned property leasing, mine development and industry investment, etc.

In October 2020, the Daye government transferred 84.13% of shares of Daye Zhenheng Urban Development Investment Co., Ltd. free of charge to Hubei New Tongdu City Investment Development Group Co., Ltd., a newly set up subsidiary of HOVE. Daye Zhenheng Urban Development Investment Co., Ltd., which name was changed to Hubei Jingchu Investment Development Co., Ltd. ("HJID") in July 2022, is the major infrastructure development and city operations entity, including water supply, sewage treatment and public bus, etc., in Daye. HJID retained a relatively high degree of independence after the equity transfer, especially in operations and financial management. At end-September 2022, HOVE held 88.55% of shares of HJID indirectly; The CDB Development Fund Co., Ltd. held the rest of 15.45%.

Currently, the Daye government holds 100% equity in HOVE through Daye SASAB, and is the ultimate controller of the company.

## Strategic Importance and Government Linkage

### Strategic Importance of HOVE to Daye

As the majority shares of HJID were transferred to HOVE in 2020, the company has become the most important LIDC that is responsible for land consolidation and infrastructure construction in Daye. Its project scope mainly includes roads, drainage networks, settlement houses, industrial parks, schools, afforestation, etc. The company is also responsible for most land consolidation in Daye. The company also participates in city operations, including water supply and sewage treatment, as well as public transportation. In addition, the Daye government authorized HOVE to administer Daye Transportation Investment Co., Ltd. ("DTIC"), the major transportation infrastructure investment entity in Daye. However, HOVE had no ownership of DTIC. HOVE's business operations and strategic planning have been aligned with the local government's economic and social development policies.

### Linkage with the Local Government

The Daye government holds 100% equity in HOVE through Daye SASAB, and is the ultimate controller of the company. The Daye government supervises the company, including senior management appointment and decision-making on investment and financing plans through Daye SASAB. In addition, Daye SASAB has set up an annual assessment mechanism for and regularly appoints auditors to review its operating performance and financial position.

### Government Support

HOVE received increasing financial subsidies from the Daye government in the past three years, amounting to RMB416 million, 587 million, 626 million and 539 million in 2019, 2020, 2021 and the first nine months of 2022, respectively. These subsidies were provided to support HOVE's operations relating to delivering public goods and public services. We

expect HOVE to enjoy ongoing financial subsidies in the future. In addition, the Daye government injected assets of RMB741 million (mainly forest rights) into HOVE in 2021. However, we believe these assets mostly are not-for-profit in nature.

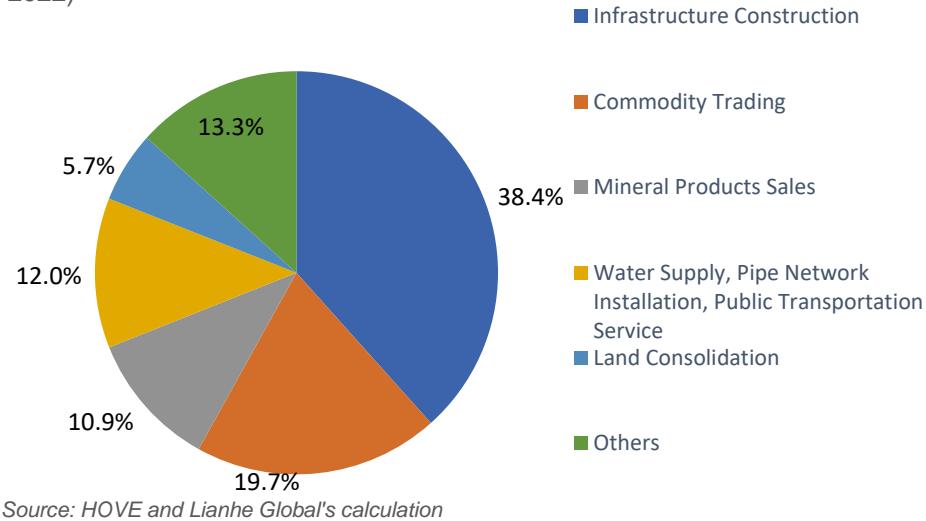
## Business Profile

### The Most Important LIDC Responsible for Infrastructure Construction, Land Consolidation and City Operations in Daye

HOVE is the most important LIDC responsible for land consolidation and infrastructure construction in Daye. The company also participates in water supply and sewage treatment, as well as city transportation operations (mainly buses and taxis), playing an important role in city operations in Daye. In addition, HOVE has engaged in trading business and mineral product sales business since 2022. HOVE's revenue maintained steady growth in the past three years, reaching c. RMB1.1 billion, 1.2 billion, 1.7 billion and 1.3 billion in 2019, 2020, 2021 and the first nine months of 2022, respectively.

#### Revenue Breakdown

(Total Revenue: RMB1.3 billion for the first-nine months of 2022)



#### Infrastructure Construction

HOVE undertakes urban infrastructure and public facility projects for the Daye government. The project scope mainly includes roads, drainage networks, settlement houses, industrial parks, schools, afforestation, etc. Under agent construction agreements, HOVE usually receives construction costs plus a margin of 15% as the management fee after the completion and acceptance of the project.

The agent construction management fee was the largest source of revenue of HOVE, contributing to c. 41% of its total revenue in the first nine months of 2022. HOVE recognized revenue of RMB470 million, 545 million and RMB377 million from infrastructure construction in 2019, 2020 and 2021, respectively. The segment's gross margin was maintained stably at c.12% in the past three years.

HOVE also involves in self-operated projects, including three centers (the commercial center, administration center and financial center) development project, the football park project and

Daye North Railway Station commercial street. These projects are to be held for leasing. In addition, the Daye government designated HOVE to develop nonmetal mines in Daye, bringing mineral product sales income of RMB144 million to the company in the first nine months of 2022. At end-2021, the HOVE had six self-operated projects under construction with a total investment of RMB4.9 billion, of which RMB915 million had been invested.

At end-2021, HOVE had agent construction projects with a total investment of RMB20.5 billion, and there were RMB6.4 billion scheduled to be invested. The company also had planned projects with a total investment of RMB2.9 billion. Considering HOVE's strong project pipeline, we expect the infrastructure construction segment to remain as the company's major source of income in the coming years.

### **Land Consolidation**

HOVE has been commissioned to undertake land consolidation in Daye by the Land Acquisition and Reserve Center of Daye ("Daye LARC") since 2010. HOVE is responsible for fundraising and contrasting designated land consolidation projects.

Before January 2020, HOVE shared 60% of the land transfer income, and Daye LARC enjoyed the rest of 40%. Yet HOVE signed a new three-year commissioned contract with Daye LARC in December 2019. Under the new contract, Daye LARC paid HOVE for the construction costs plus a fixed margin of 40% for the land consolidation projects upon completion and passing the acceptance inspection. LARC settles related payments with HOVE annually, regardless of the land transfer processes.

HOVE recognized revenue of RMB264 million, 341 million, 529 million and 75 million from land consolidation in 2019, 2020, 2021 and nine-month ended September 2022, respectively. The increasing trend in 2019-2021 was mainly due to the expanding size of delivered lands. Also, the segment's gross margin has stayed at c.27% since 2020.

### **Commodity Trading and Mineral Product Sales**

HOVE has engaged in commodity trading and mineral product sales since 2022. The company mainly trades nonferrous metals such as electrolytic copper. The company usually settles in cash with its suppliers and buyers, and doesn't keep inventory to control the market and counterparty credit risks. However, the trading business's gross margin was as low as c.0.3% in the first nine months of 2022. HOVE also sells mineral products (mainly limestone) exploited from its self-owned mines. They generated a much higher gross margin of 34.5% over the same period.

The commodity trading and mineral product sales have become the second largest and the third largest revenue drivers, amounting to RMB260 million and RMB144 million and accounting for c. 21% and c.12% of HOVE's total revenue, respectively, in the first nine months of 2022. We expect they to further develop as strong revenue drivers of HOVE in the coming years.

### **Water Supply, Pipe Network Installation, Public Transportation Service and Other businesses**

HOVE is also responsible for operating public services and facilities in Daye, including the water supply, sewage treatment, water pipe network installation and public transportation service.

HOVE is the major water supply and sewage treatment company in Daye, serving most residential and business users in the Daye city area and neighboring townships. It also is the only company that provides public transportation services (mainly including public buses and taxis) in Daye. Due to the strategic importance of those public services to Daye, the Daye government provided stable and ongoing financial subsidies to support HOVE's operation.

HOVE's other businesses mainly include leasing of state-owned properties and advertising, which have high margins but contribute only a small fraction of the company's total revenue.

## Financial Profile

### Balance Sheet Structure and Quality

Balance Sheet Structure and Quality (RMB million)	2019	2020	2021	Sep 2022
Total Asset	46,773	48,713	50,530	56,694
Equity	25,866	25,729	26,340	26,546
Debt	19,256	20,935	19,819	23,585
Debt / (Debt + Equity) (%)	42.7	44.9	42.9	47.1
LT Debt	12,448	11,080	11,896	14,236
LT Debt / (LT Debt + Equity) (%)	32.5	30.1	31.1	34.9

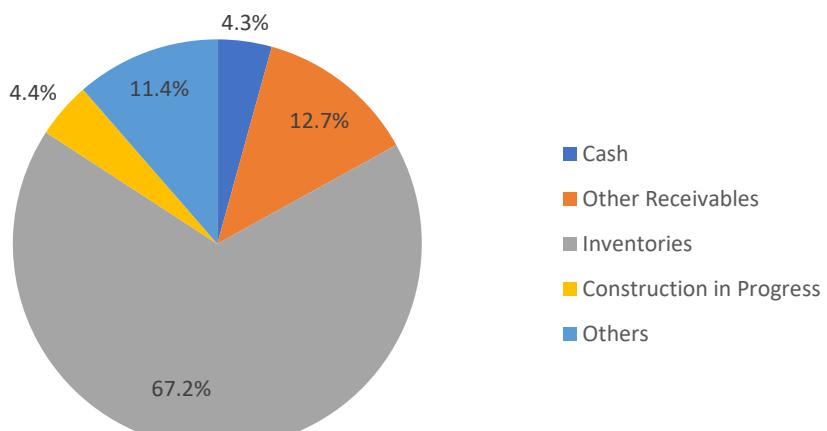
Source: HOVE and Lianhe Global's calculations

HOVE's balance sheet structure was largely stable between 2019 and 2021. Its asset size grew moderately to RMB50.5 billion at end-2021 from RMB46.8 billion at end-2019, representing a CAGR of 3.9%. Its total debts increased slightly to RMB19.8 billion from RMB19.3 billion over the same period. As measured by debts/capitalization, the company's financial leverage stayed at a manageable level of c.42-45% in the past three years.

HOVE speeded up its expansion in the first nine months of 2022. Its total assets increased by 12.2% to RMB56.7 billion, while its total debts increased by 19.0% to RMB23.6 billion at the end of September 2022, lifting the company's financial leverage to 47.1%. Inventories and the construction in progress contributed c.90% of HOVE's asset expansion.

### Asset Breakdown

(Total Assets: RMB56.7 billion at end-September 2022)



HOVE's asset liquidity was relatively weak. At end-September 2022, the company had inventories of RMB38.1 billion, accounting for 67.2% of the company's total assets. The company's inventories mainly included lands to be developed of RMB21.8 billion, completed projects of RMB12.6 billion and construction costs of RMB3.7 billion. They usually take a long time to be converted to cash due to the long planning, construction and recognition period. In addition, a large proportion of HOVE's inventory lands was injected by the government free of charge. Their usage and transfer are subject to certain regulations, and thus could be lack of liquidity. HOVE also acquired land through open bids and held it for future development or resale.

In addition, HOVE had other receivables of RMB7.2 billion at end-September 2022, accounting for 12.7% of its total assets, mainly due from other government agencies and LIDCs and a significant proportion of other receivables technically were loans. HOVE usually takes two to three years to collect its receivables, except the outstanding of RMB2.9 billion due from Daye Jingchuang Asset Management Co., Ltd. ("DJAM"), another LIDC fully owned by Daye SASAB. That initially was the account receivable of c. RMB4.2 billion due from Hubei Daye Hanlong Automobile Co., Ltd. that had stopped operation since 2020. It was transferred to DTIC in 2020, and to DJAM in 2021 under the government's instruction and booked on HOVE's other receivables. DJAM should repay HOVE in five years. However, the actual payment was far behind schedule.

Other assets mainly included properties for leasing and mining rights.

## Cash Flow

Cash Flow (RMB million)	2019	2020	2021	9M2022
Cash Inflows from Operation	1,977	2,240	4,863	10,911
Cash Outflows from Operation	1,958	2,189	3,163	9,350
<b>Net CF from Operation</b>	<b>19</b>	<b>51</b>	<b>1,700</b>	<b>1,561</b>
Cash Inflows from Investment	75	212	0	2
Cash Outflows from Investment	1,625	809	989	2,042
<b>Net CF from Investment</b>	<b>-1,550</b>	<b>-597</b>	<b>-989</b>	<b>-2,040</b>
Cash Inflows from Financing	4,965	6,664	8,830	7,730
Cash Outflows from Financing	4,942	6,252	9,712	7,019
<b>Net CF from Financing</b>	<b>23</b>	<b>412</b>	<b>-882</b>	<b>711</b>
Net Increase in Cash and cash equivalent	-1,508	-134	-171	232

Source: HOVE and Lianhe Global's calculations

## Debt Servicing Capability

HOVE's liquidity was tight. At end-September 2022, HOVE had cash of RMB2.4 billion (including restricted cash of RMB1.7 billion), compared with its debts due within one year of RMB9.3 billion. Yet the company also had available bank credit lines of RMB14.2 billion. These could support HOVE's refinance and operations to some extent.

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