

Qingdao Development Zone Investment and Construction Group Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BBB
Outlook	Stable
Location	China
Industry	Local Investment and Development Companies
Date	27 October 2023

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned ‘BBB’ global scale Long-term Issuer Credit Rating with Stable Outlook to Qingdao Development Zone Investment and Construction Group Co., Ltd. (“QDZIC” or “the company”)

Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of West Coast New Area, Qingdao City (“West Coast New Area government”) would provide strong support to QDZIC if needed, in light of its indirect full ownership of QDZIC, QDZIC’s strategic importance as the key local investment and development company (“LIDC”) responsible for infrastructure construction and state-owned asset management in the West Coast New Area, Qingdao City (“West Coast New Area”), especially in the Qingdao Economic and Technological Development Zone (“Qingdao EDZ”), and the linkage between the West Coast New Area government and QDZIC, including management appointments, strategic alignment, supervision of major investment and financing plans and ongoing operational and financial support. In addition, the West Coast New Area government may face significant negative impact on its reputation and financing activities if QDZIC encounters any operational and financial difficulties.

The Stable Outlook reflects our expectation that QDZIC’s strategic importance would remain intact while the West Coast New Area government will continue to ensure QDZIC’s stable operation.

Rating Rationale

West Coast New Area Government’s Ownership and Supervision: The West Coast New Area government holds 100% ownership of QDZIC through the Qingdao West Coast New Area State-owned Assets Administration (“West Coast New Area SAA”) and other LIDCs in the region. The West Coast New Area government has the final decision-making authority and supervision over the company, including management appointments, strategic development and investment planning, and major funding decisions. In addition, the West Coast New Area government has assessment mechanism over the company and appoints auditors to supervise the operating performance and financials on a periodic basis.

Strategic Importance to West Coast New Area and Strategic Alignment: QDZIC, as the main implementation entity for infrastructure construction in Qingdao EDZ, plays an important role in promoting the economic development of the region. It undertakes the vast majority of the infrastructure projects in Qingdao EDZ. The company is also responsible for the industrial park operation, urban service operation, regional area development, culture and tourism development within Qingdao EDZ with strong regional advantages. QDZIC’s business operation and development have been aligned with the government’s development plans.

Ongoing Government Support: QDZIC continued to receive financial subsidies, funding and asset/capital injections from the local government to support its business operations. We believe that the government support will remain intact given the company’s strategic role in the economic development of the West Coast New Area and Qingdao EDZ. In 2020-

Key Figures of West Coast New Area and QDZIC

(RMB billion)	2021	2022
West Coast New Area		
GDP	436.9	469.2
GDP growth rate (%)	10.3	4.8
Budgetary revenue	26.1	22.4
Government fund	25.6	19.5
Transfer payment	6.6	7.5
Budgetary expenditure	25.5	24.2
QDZIC		
Assets	36.0	42.0
Equity	14.0	16.1
Revenue	11.6	6.4

Source: Public information, QDZIC and Lianhe Global’s calculations

Analysts

Jack Li, CESGA
 (852) 3462 9585
jack.li@lhratingsglobal.com

Joyce Huang, CFA
 (852) 3462 9586
joyce.huang@lhratingsglobal.com

Applicable Criteria

China Local Investment and Development Companies Criteria (5 December 2022)

1H2023, QDZIC received subsidies totaling around RMB60.4 million. Meanwhile, the company received project assets (such as shantytown redevelopment projects), fiscal funds, government debt-to-loan funds, and capital injections from the West Coast New Area government. Besides, the West Coast New Area government provides policy supports and tax deductions to QDZIC.

QDZIC's Financial and Liquidity Position: QDZIC's total assets more than doubled to RMB42.0 billion at end-1H2023 from RMB18.1 billion at end-2020. The increase in QDZIC's total assets was primarily due to the higher current asset from the start of several infrastructure projects. Although QDZIC's current assets accounted for a significant portion of total assets (about 70.6% at end-1H2023), overall asset liquidity was weak due to its high development costs. QDZIC's total adjusted debt increased significantly to RMB21.4 billion at end-1H2023 from RMB8.5 billion at end-2020. QDZIC mainly relies on external financing to support its capital expenditures and debt repayments, which we expect to continue.

The liquidity of QDZIC was sufficient. At end-June 2023, QDZIC had unrestricted cash balance and unused credit facilities of RMB3.6 billion and RMB7.6 billion, respectively, compared with its debt due within one year of RMB7.7 billion. Besides, QDZIC has access to various financing channels, including bank loans, bond issuance and non-traditional financing, to support its debt repayments and business operations.

Economy and Fiscal Condition of West Coast New Area: The West Coast New Area is located in the southwest of the Qingdao City. It is one of the seven urban districts of Qingdao. West Coast New Area recorded an economic growth in 2022, achieving a GDP of RMB469.2 billion, with a year-on-year growth of 4.8%. Its total GDP ranks first among all districts and counties in Qingdao. The aggregate fiscal revenue of the West Coast New Area government was mainly derived from the budgetary revenue and government fund income.

In 2022, the budgetary revenue of the West Coast New Area government reached RMB22.4 billion, but the tax revenue decreased due to the large-scale value-added tax credit refunds to support the economy. At the same time, the government fund income was more volatile, dropping to RMB19.5 billion in 2022 from RMB25.6 billion in 2021. The fiscal self-sufficiency rate of the West Coast New Area government was sufficient, but it recorded budget deficit of 8.0% in 2022, the first budget deficit in the past few years. Given that the West Coast New Area government borrowed heavily in special debts to support its public projects, its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, increased to 107.8% at end-2022 from 19.6% at end-2018.

Rating Sensitivities

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

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

Operating Environment

Economic Condition of West Coast New Area

West Coast New Area, also known as Huangdao District, is an administrative district of Qingdao City, Shandong Province, located in the southwest of Qingdao. By the end of 2021, West Coast New Area had a total area of 2,128 square kilometers, jurisdiction over 10 functional areas, 14 streets, and a residential population of 1.96 million, with an urbanization rate of 82.8%.

West Coast New Area maintained steady economic growth in the past three years. West Coast New's GDP reached RMB469.2 billion, representing a year-over-year growth rate of 4.8% in 2022, and its GDP ranked the first among all districts and counties under the administration of Qingdao. West Coast New Area's economic growth was entirely fueled by the secondary and tertiary industries in the past few years, which accounted for 35.9% and 62.1% in 2022, respectively. GDP per capita of West Coast New Area was RMB238,900 in 2022, which was higher than the GDP per capita of China (RMB85,700) as well as that of Qingdao (RMB145,400).

West Coast New Area's GDP and Fixed Asset Investment			
(RMB billion)	2020	2021	2022
GDP	372.2	436.9	469.2
-Primary industry (%)	2.2	2.1	2.0
-Secondary industry (%)	37.6	37.5	35.9
-Tertiary industry (%)	60.2	60.4	62.1
GDP growth rate (%)	3.9	10.3	4.8
Fixed asset investment	343.0	358.8	377.1
Fixed asset investment growth rate (%)	1.5	4.6	5.1
Population (million)	1.9	2.0	2.0

Source: Public information and Lianhe Global's calculations

Fiscal Condition of West Coast New Area

The West Coast New Area government's aggregate fiscal revenues are mainly derived from budgetary revenue and government fund income. The tax revenue accounted for 70%-78% of its budgetary revenue between 2020 and 2022. The fiscal self-sufficiency rate of the West Coast New Area government was sufficient, but it recorded budget deficit of 8.0% in 2022, the first budget deficit in the past few years. Moreover, the government fund income was fluctuant, of which the growth rate was -25.1%, 7.5% and -23.9% in 2020, 2021 and 2022, respectively.

The outstanding debt of the West Coast New Area government continued to grow. At end-2022, the West Coast New Area government's outstanding debt was RMB53.3 billion, including RMB4.3 billion of general obligations and RMB49.0 billion of special debt. Given that the West Coast New Area government borrowed heavily in special debts to support its public projects, its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 107.8% at end-2022 from 19.6% at end-2018.

West Coast New Area's Fiscal Condition			
(RMB billion)	2020	2021	2022
Budgetary revenue	25.7	26.1	22.4
Budgetary revenue growth rate (%)	0.9	1.5	2.7*

Tax revenue	19.7	20.2	15.8
Tax revenue (% of budgetary revenue)	76.5	77.5	70.4
Government fund income	23.8	25.6	19.5
Transfer payment	5.1	6.6	7.5
Aggregate revenue	54.6	58.3	49.4
Budgetary expenditure	22.2	25.5	24.2
Budget balance ¹ (%)	13.5	2.1	-8.0

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

Source: Public information and Lianhe Global's calculations

Note*: Excluding the influence of value-added tax credit refund

Ownership Structure

Government's Ownership

QDZIC was established in May 2017 with an initial registered capital of RMB1.0 billion, funded by Chengfa Investment Group Co., Ltd. ("CIG") and West Coast New Area SAA, which formerly known as Qingdao Huangdao District State-owned Assets Management Office. After an array of capital injection, the registered capital of the company was increased to RMB2.0 billion in November 2017. In March 2020, West Coast New Area SAA transferred its equity shares to Qingdao Military-Civilian Integration Development Group Co., Ltd. ("QMCI").

At end-June 2023, QDZIC's registered and paid-in capital were RMB2.0 billion and RMB0.87 billion, respectively. QDZIC had a shareholding structure in which the QMCI, as the controlling shareholder, held 60% of the company's equity, and the remaining 40% equity was held by CIG. West Coast New Area SAA was the actual controller of the company.

Strategic Importance and Government Linkage

Strategic Importance of QDZIC to West Coast New Area

QDZIC, as the main implementation entity for infrastructure construction in Qingdao EDZ, plays an important role in promoting the economic development of the region. It undertakes the vast majority of the infrastructure projects in Qingdao EDZ. The company is also responsible for the industrial park operation, urban service operation, regional area development, culture and tourism development within Qingdao EDZ with strong regional advantages. QDZIC's business operation and development have been aligned with the government's development plans.

Strong Linkage with the Local Government

QDZIC's linkage with the local government is strong as the West Coast New Area government indirectly holds 100% ownership of QDZIC through the West Coast New Area SAA and other LIDCs in the region. The West Coast New Area government has the final decision-making authority and supervision over the company, including management appointments, strategic development and investment planning, and major funding decisions. In addition, the West Coast New Area government has assessment mechanism over the company and appoints auditors to supervise the operating performance and financials on a periodic basis.

Government Support

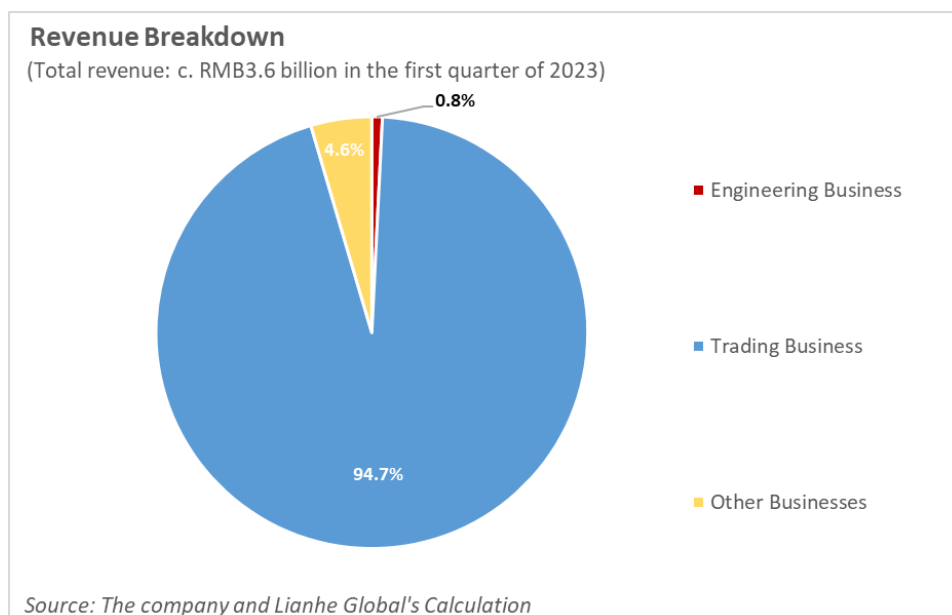
QDZIC continued to receive financial subsidies, funding and asset/capital injections from the local government to support its business operations. We believe that the government support will remain intact given the company's strategic role in the economic development of the West Coast New Area and Qingdao EDZ. In 2020-1H2023, QDZIC received subsidies totaling around RMB60.4 million. Meanwhile, the company received project assets (such as shantytown redevelopment projects), fiscal funds, government debt-to-loan funds, and capital injections from the West Coast New Area government totaling around RMB6.6 billion. Besides, the West Coast New Area government will repurchase some infrastructure construction projects and provide policy supports and tax deductions to ensure its business operation.

Business Profile

The Key Entity Responsible for Infrastructure Construction in West Coast New Area

QDZIC, as an important LIDC in West Coast New Area, is mainly responsible for the urban infrastructure construction in Qingdao EDZ, which is one of the ten functional zones of West Coast New Area. The company's franchise advantage enables it to undertake important infrastructure construction projects under the instruction of the West Coast New Area SAA. The company has received strong support from shareholders and the government in terms of fiscal subsidies and capital injection, which enhances the capital strength and profitability of the company.

The primary sources of operating revenue for QDZIC are trading business and engineering business, while it also engages in concrete production and sales, casting production and sales, construction and installation, commercial property business, etc. The company's total revenue reached RMB9.0 billion, RMB8.6 billion, RMB11.5 billion and RMB3.6 billion in 2020, 2021, 2022 and the first quarter of 2023, respectively. The overall gross profit margin of QDZIC was relatively low at 2.5%-4.5% from 2020 to the first quarter of 2023. In general, QDZIC's business was relatively concentrated, and it has regional advantages in its major businesses.



Engineering Business

QDZIC undertakes infrastructure construction within the West Coast New Area, including agent engineering and village renovation. The projects in this segment are generally conducted under the agent construction model, where the revenue recognition includes construction costs incurred plus a certain percentage of profit. Its revenue in this segment was relatively stable at RMB0.2 billion, RMB0.2 billion and RMB0.3 billion in 2020, 2021 and 2022, respectively, with stable gross profit margin of 9%-13%. However, its revenue plummeted to RMB28 million in the first quarter of 2023, mainly due to seasonal factors. Currently, some of the company's projects are funded by special government funds, and projects under construction and to be constructed still require a large scale of investment. Thus, it incurs high pressure on capital expenditure.

Trading Business

As a major source of revenue for QDZIC, the trading segment plays an important role to its business structure. QDZIC mainly engages in the sales of wood, steel, cement, cotton, rubber, etc. As the expansion of the trading scale and transfer of subsidiaries, the company's revenue in this segment had become more volatile since 2020. The revenue generated from this segment reached RMB8.5 billion, RMB7.7 billion, RMB10.2 billion and RMB3.4 billion in 2020, 2021, 2022 and the first quarter of 2023, respectively. The gross profit margin of the segment was relatively low at below 2% for the past years. The suppliers and customers of the segment are diversified, indicating a relatively low counterparty risk.

Other Businesses

Other businesses of QDZIC include concrete production and sales, casting production and sales, construction and installation, commercial property business, etc., with each segment accounted for a relatively small proportion of the company's total revenue. Other businesses mainly play the role of supplementing the revenue of the main business and make the revenue structure more diversified.

Financial Profile

Balance Sheet Structure and Quality

Balance Sheet Structure and Quality				
(RMB million)	2020	2021	2022	June 2023
Total Asset	18,132	29,439	36,038	41,963
Equity	7,274	10,795	14,025	16,098
Debt	8,492	13,247	17,097	21,423
Debt/(Debt+Equity) (%)	53.9	55.1	54.9	57.1
LT Debt	4,865	8,557	10,449	13,772
LT Debt/(LT Debt+Equity) (%)	40.1	44.2	42.7	46.1

Source: QDZIC's 2023 interim report, 2020-2022 audited annual report and Lianhe Global's calculation

QDZIC's asset size had experienced a rapid growth since 2020. The company's total asset increased to RMB36.0 billion at end-2022 from RMB18.1 billion at end-2020, representing a CAGR of 41.0%. It further increased by 16.4% to RMB42.0 billion at end-June 2023. The surge of QDZIC's total assets was largely due to the higher current asset from the start of several infrastructure projects. The current asset contributed 70.6% of QDZIC's total assets

at end-June 2023, and it consisted of inventory and cash, including completed but not yet settled projects, land to be developed and construction costs, as well as bond financing. With continued investment in infrastructure projects, QDZIC's inventory increased to RMB16.4 billion at end-June 2023, representing 39.2% of QDZIC's total asset. At the same time, QDZIC had cash of RMB5.4 billion, representing 12.9% of QDZIC's total asset.

In addition, QDZIC had other non-current assets of RMB12.3 billion at end-June 2023, representing 29.4% of the company's total asset, due to the increase of intangible asset. Due to the long construction, recognition and payment period, QDZIC's project-related assets could take a prolonged period to convert to cash. Whereas, we expect local governments and state-owned enterprises to pay QDZIC accordingly to ensure that QDZIC is able to meet its financial obligations when they become due.

QDZIC's financial leverage (total liabilities to assets) remained stable at 59.9%, 63.3%, 61.1% and 61.6% at end-2020, end-2021, end-2022, and end-June 2023, respectively. The potential increase is contingent upon the requirements of ongoing project construction, with a limit set at 70% to comply with government oversight. QDZIC relied heavily on borrowings to finance its businesses. The total adjusted debts of the company had an upward trend since 2020, which increased to RMB17.1 billion at end-2022 from RMB8.5 billion at end-2020, representing a CAGR of 41.4%. It further increased to RMB21.4 billion as of the end of June 2023, with short-term debt accounting for 35.7% of the total debt. Consequently, the total debt ratio and long-term debt ratio reached 54.9% and 42.7% at end-2022, respectively. At end-June 2023, the total debt ratio and long-term debt ratio further increased to 57.1% and 46.1%, respectively.

Debt Servicing Capability

The liquidity of QDZIC was sufficient. At end-June 2023, QDZIC had unrestricted cash balance and unused credit facilities of RMB3.6 billion and RMB7.6 billion, respectively, compared with its debt due within one year of RMB7.7 billion. Besides, QDZIC has access to various financing channels, including bank loans, bond issuance and non-traditional financing, to support its debt repayments and business operations.



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