

Linyi Eastern City Construction Investment Group Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BBB-
Outlook	Stable
Location	China
Industry	Local Investment and Development Companies
Date	12 January 2024

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned ‘BBB-’ global scale Long-term Issuer Credit Rating with Stable Outlook to Linyi Eastern City Construction Investment Group Co., Ltd. (“LECCI” or “the company”)

Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of Hedong District, Linyi City (“Hedong government”) would provide strong support to LECCI if needed, in light of its full ownership of LECCI, LECCI’s strategic importance as the key local investment and development company (“LIDC”) that is responsible for infrastructure construction and industrial park development in Hedong District, Linyi City (“Hedong”), and the linkage between the Hedong government and LECCI, including appointment and supervision of the senior management, strategic alignment, major investment and financing plan decisions and ongoing operational and financial support. In addition, the Hedong government may face significant negative impact on its reputation and financing activities if LECCI encounters any operational and financial difficulties.

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

Rating Rationale

Hedong Government’s Ownership and Supervision: The Hedong government holds the full ownership of LECCI through the Finance Bureau of Hedong District (“Hedong FB”). The Hedong government is the actual controller of the company. It has the final decision-making authority and supervises the company, including management appointment, decision on its strategic development and investment plan and supervision of its major funding decisions. In addition, the Hedong government has assessment mechanism over the company and appoints auditors to supervise the operating performance and financial position on a periodic basis.

Strategic Importance to Hedong and Strategic Alignment: LECCI, as the key LIDC in Hedong, is primarily responsible for the investment, development and operation of infrastructure projects and industrial park development within the city. LECCI is mainly engaged in the urban renewal of the two main district in Hedong and operates as the main industrial park developer and operator with strong regional advantages. Its primary responsibilities include overseeing the urban renewal projects in areas such as Beijing East Road and managing the construction and operation of industrial parks, including those dedicated to smart hardware and solar photovoltaics. LECCI plays an important role in promoting the economic and social development of the region. Its business operation and development have been aligned with the government’s development plans.

Ongoing Government Support: LECCI received operational and financial support from the government. LECCI received a total subsidy amount of RMB481.6 million from 2020 to the first nine months of 2023. The Hedong government continued to inject capital, real estate assets, right of use asset, equities of other companies and other kinds of assets into LECCI to expand its asset size and diversify its business. Besides, the Hedong government will repurchase some infrastructure projects and provide policy supports to

Key Figures of Hedong and LECCI (RMB billion)

	2021	2022
Hedong		
GDP	27.9	29.7
GDP growth rate (%)	10.3	5.1
Budgetary revenue	2.2	2.2
Government fund	0.2	0.2
Transfer payment	3.3	3.4
Budgetary expenditure	4.7	4.3
LECCI	2022	2023.9
Assets	11.9	14.2
Equity	6.3	6.4
Revenue	1.3	0.6

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

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Applicable Criteria

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

LECCI to ensure its business operation. Given that it is the key entity for infrastructure construction and industrial park development in Hedong, LECCI has an advantage in acquiring related resources and major projects. We believe LECCI is likely going to receive government support to support its daily business operation.

LECCI's Financial Matrix and Liquidity Position: LECCI's total assets showed a continuous growth trend in the past years and reached RMB14.2 billion at end-September 2023, mainly due to the increase of inventories. The non-current assets of LECCI accounted for 38.7% of the total assets at end-September 2023, yet the overall asset liquidity was moderately weak due to large amount of inventories and intangible assets. LECCI's financial leverage (total liabilities to total assets) was 55.3% and its adjusted debt increased to RMB4.2 billion at end-September 2023 from RMB1.0 billion at end-2021. The liquidity of LECCI was sufficient. At end-September 2023, LECCI had a cash balance and unused credit facilities of RMB1.5 billion and RMB4.3 billion, respectively, compared with its debt due within one year of RMB1.0 billion. Besides, LECCI has access to various financing channels, including bank loans and non-traditional financing, to support its debt repayment and business operations.

Economy and Moderate Fiscal Strength of Hedong: Hedong realized GDP of RMB29.7 billion in 2022, representing a year-on-year growth rate of 5.1%. Its GDP scale was ranked 9th in all jurisdictions of Linyi City, Shandong Province ("Linyi") in 2022. Hedong has jurisdiction over 8 streets and 3 towns, with a total area of 613.4 square kilometers. At end-2022, Hedong had a resident population of 0.5 million, with an urbanization rate of 61.4%.

The Hedong government's aggregate fiscal revenues are mainly derived from budgetary revenue and transfer payment from higher government. The Hedong government's budgetary revenue maintained relatively stable growth in the past few years and reached RMB2.2 billion in 2022. Its fiscal self-sufficiency was improving but remained weak, with budget deficits of 100.1% in 2022. Therefore, the Hedong government highly relied on transfer payments from higher government. The government fund income, mainly generated by land sales, reached RMB0.2 billion in 2022 from, representing a relatively low level. The outstanding debt of the Hedong government continued to grow in the past few years, recording at RMB8.2 billion at end-2022. Its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 142.7% at end-2022 from 97.1% at end-2020, mainly due to the increase in special debt.

Rating Sensitivities

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

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

Operating Environment

Economic Condition of Hedong

Hedong is a district directly under the jurisdiction of Linyi. Located in the southeastern part of Shandong Province, specifically in the eastern part of Linyi, Hedong has jurisdiction

over 8 streets and 3 towns, with a total area of 613.4 square kilometers. At end-2022, Hedong had a resident population of 0.5 million, with an urbanization rate of 61.4%.

Hedong's GDP growth rate fluctuated in the past three years, owing to Covid's disruption, which was 5.0%, 10.3% and 5.1% in 2020, 2021 and 2022, respectively. Hedong's GDP reached RMB29.7 billion in 2022, which was ranked 9th in all jurisdictions of Linyi. Hedong's economic growth was mainly fueled by the secondary and tertiary industries, which accounted for 27.8% and 67.2% in 2022, respectively. GDP per capita of Hedong reached RMB54,800 in 2022, which was higher than that of Linyi (RMB52,500).

Hedong's GDP and Fixed Asset Investment			
(RMB billion)	2020	2021	2022
GDP	30.4	27.9	29.7
-Primary industry (%)	5.0	6.1	5.0
-Secondary industry (%)	28.3	38.2	27.8
-Tertiary industry (%)	66.7	55.7	67.2
GDP growth rate (%)	5.0	10.3	5.1
Fixed asset investment	22.3	25.2	30.2
Fixed asset investment growth rate (%)	7.9	13.2	19.6
Population (million)	0.5	0.5	0.5

Source: Public information and Lianhe Global's calculations

Fiscal Condition of Hedong

The Hedong government's aggregate fiscal revenues are mainly derived from budgetary revenue and transfer payment from higher government. The Hedong government's budgetary revenue maintained relatively stable growth in the past few years and reached RMB2.2 billion in 2022. Having said that, the budgetary revenue growth rate slowed down in 2022, from 14.9% in 2021 to 2.5%, due to the large-scale value-added tax credit refund policies to support the economy. Its fiscal self-sufficiency was improving but remained weak, with budget deficits of 100.6% in 2022. Therefore, the Hedong government highly relied on transfer payments from higher government. The government fund income, mainly generated by land sales, reached RMB0.2 billion in 2022 from, representing a relatively low level.

The outstanding debt of the Hedong government continued to grow in the past few years, recording at RMB8.2 billion at end-2022. Its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 142.7% at end-2022 from 97.1% at end-2020, mainly due to the increase in special debt.

Hedong's Fiscal Condition			
(RMB billion)	2020	2021	2022
Budgetary revenue	1.9	2.2	2.2
Budgetary revenue growth rate (%)	9.5	14.9	2.5
Tax revenue	1.8	2.0	1.8
Tax revenue (% of budgetary revenue)	94.0	89.0	84.9
Government fund income	0.1	0.2	0.2
Transfer payment	3.4	3.3	3.4
Aggregate revenue	5.4	5.7	5.7
Budgetary expenditure	4.6	4.7	4.3
Budget balance ¹ (%)	-136.4	-110.0	-100.6

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

*Excluding the influence of value-added tax credit refund

Source: Public information and Lianhe Global's calculations

Ownership Structure

Government's Ownership

LECCI was established in November 2015 with an initial registered capital of RMB100 million, funded by the Hedong FB. After an array of capital injections from its shareholder, the company's registered and paid-in capital were both enlarged to RMB0.5 billion. LECCI had a shareholding structure in which the Hedong FB, as the sole shareholder and actual controller of the company, held 100% of the company's equity.

Strategic Importance and Government Linkage

Strategic Importance of LECCI to Hedong

LECCI, as the key LIDC in Hedong, is primarily responsible for the investment, development and operation of infrastructure projects and industrial park development within the city. LECCI is mainly engaged in the urban renewal of the two main district in Hedong and operates as the main industrial park developer and operator with strong regional advantages. Its primary responsibilities include overseeing the urban renewal projects in areas such as Beijing East Road and managing the construction and operation of industrial parks, including those dedicated to smart hardware and solar photovoltaics. LECCI plays an important role in promoting the economic and social development of the region. Its business operation and development have been aligned with the government's development plans.

Strong Linkage with the Local Government

LECCI's linkage with the local government is strong as the Hedong government holds the full ownership of LECCI through Hedong FB. The Hedong government has the final decision-making authority and supervises the company, including management appointment, decision on its strategic development and investment plan and supervision of its major funding decisions. In addition, the Hedong government has assessment mechanism over the company and it appoints auditors to supervise the operating performance and financial position on a periodic basis.

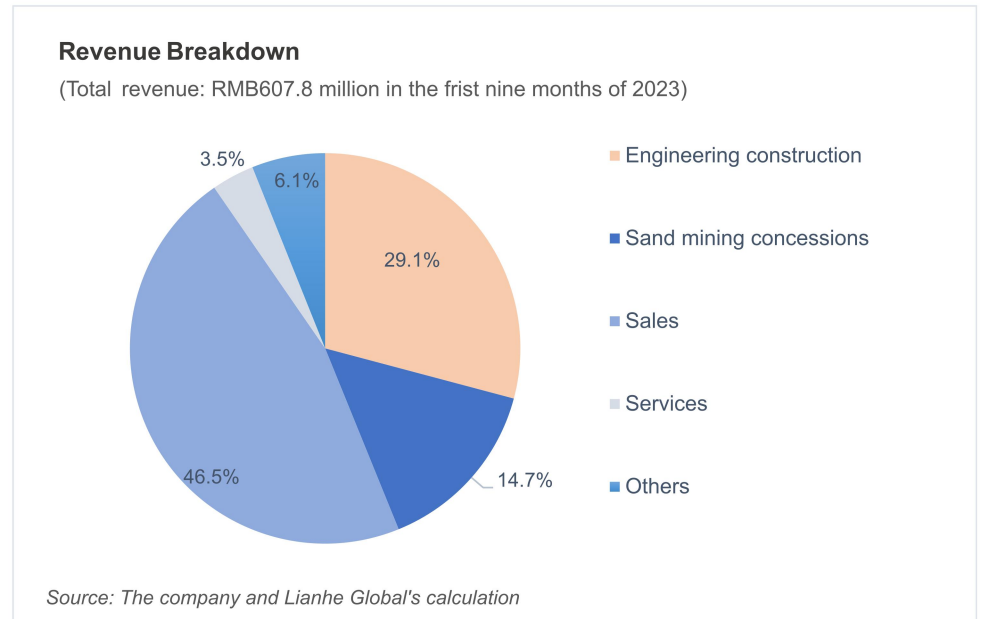
Government Support

LECCI received operational and financial support from the government. LECCI received a total subsidy amount of RMB481.6 million from 2020 to the first nine months of 2023. The Hedong government continued to inject capital, real estate assets, right of use asset, equities of other companies and other kinds of assets into LECCI to expand its asset size and diversify its business. Besides, the Hedong government will repurchase some infrastructure projects and provide policy supports to LECCI to ensure its business operation. Given that it is the key entity for infrastructure construction and industrial park development in Hedong, LECCI has an advantage in acquiring related resources and major projects. We believe LECCI is likely going to receive government support to support its daily business operation.

Business Profile

The Key Entity Responsible for Infrastructure Construction and Industrial Park Development in Hedong

LECCI, as an important LIDC in Hedong, is mainly responsible for the infrastructure construction and industrial park development within the region, with a strong regional franchise advantage. The primary sources of operating revenue for LECCI are trading and sales, engineering construction and sand mining concessions, while it also engaged in water supply, rental and other services business, etc. The company's total revenue was on an upward trend in the past few years, recording at RMB479.0 million, RMB1.1 billion and RMB1.3 billion and RMB 607.8 million in 2020, 2021, 2022 and the first nine months of 2023, respectively. Its gross profit margin fluctuated between 4.0% and 9.3% over the same period.



Engineering Construction

LECCI is a significant player in infrastructure development in the Hedong, with its infrastructure business managed by the company and its subsidiaries. The engineering construction business is divided into self-built and commissioned projects.

Under commissioned projects, the company undertakes construction work on behalf of various entities, including the Hedong FB and the Hedong District People's Government Tangtou Street Office. The projects cover municipal roads, infrastructure, resettlement housing, schools, and surrounding facilities. After project completion, the construction entity confirms and settles income based on a signed agreement with the contracting party. In the case of self-built projects, LECCI focuses on industrial park construction in the Hedong, planning to achieve profitability through methods like equity dividends, factory repurchases, sales, and rentals.

The revenue derived from this segment grew steadily in the past few years, recording at RMB298.7 million, RMB305.4 million, RMB498.6 million and RMB177.1 million in 2020, 2021, 2022, respectively, with the gross profit margin remaining around 12% over the same period. Currently, projects under construction and to be constructed still require a large scale of investment, thus it incurs high pressure on capital expenditure.

Trading and Sales

LECCI engages in a diverse range of trade categories, primarily consisting of building materials, automobiles, engineering plastics, commodity concrete, and electrical products. The automotive sales business model includes two approaches: sales-to-order procurement and market-oriented sales. In the sales-to-order procurement model, the company settles payments with suppliers and downstream customers in cash, with credit terms generally not exceeding three months for some trading partners. The company earns a fixed price difference as an intermediary in this model, resulting in a low gross profit margin.

Besides automotive sales, the sales models for other trade categories within the company predominantly follow the sales-to-order procurement approach. The revenue derived from this segment grew steadily in the past few years, recording at RMB282.8 million in the first nine months of 2023, accounting for 46.5% of the total revenue of the company. The gross profit margin remained below 1% in the past few years due to the business nature.

Other Businesses

Except for the above businesses, the company also operates other businesses including services supply, rental, water supply and sand mining concessions, etc., making the company's income structure more diversified while forming a better complement to the company's overall income.

Financial Profile

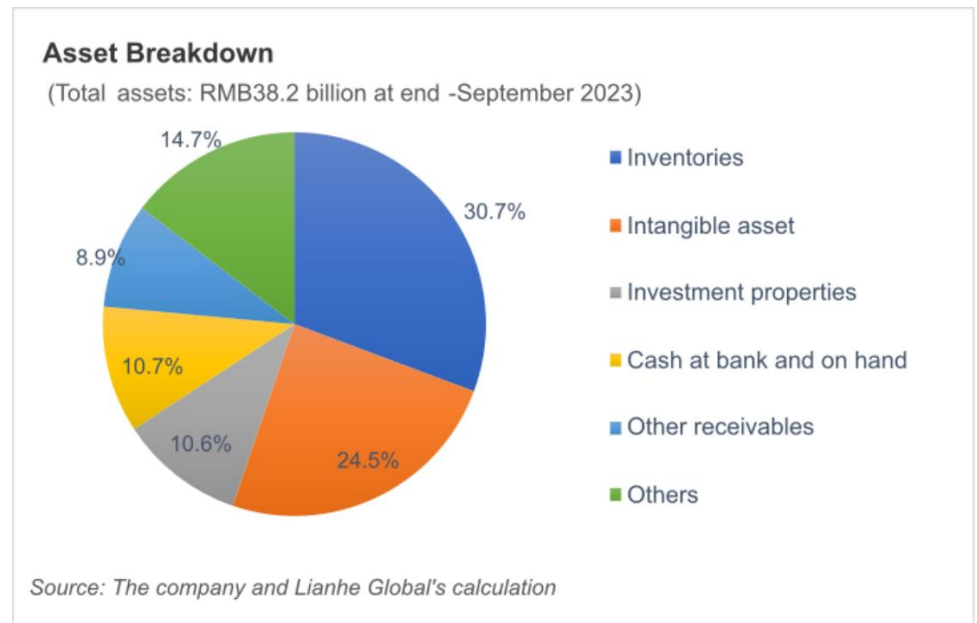
Balance Sheet Structure and Quality

Balance Sheet Structure and Quality

(RMB million)	2020	2021	2022	September 2023
Total Asset	4,704	7,584	11,881	14,239
Equity	4,303	4,853	6,257	6,362
Debt	336	1,031	2,142	4,189
Debt / (Debt + Equity) (%)	7.2	17.5	25.5	39.7
LT Debt	19	232	1,102	3,151
LT Debt / (LT Debt + Equity) (%)	0.4	4.6	15.0	33.1

Source: Company information and Lianhe Global's calculations

LECCI's total asset surged to RMB14.2 billion end-September 2023, nearly doubled compared with RMB7.6 billion recorded at end-2021. The company mainly relied on capital and asset injections from the local government to fund its asset expansion. The company's financial leverage, as measured by total liability/total asset was on an upward trend in the past few years, recording at 55.3% at end-September 2023 (end-2021: 36.0%). We expect the financial leverage of the company to stay below 60% given the government's guidance and supervision.



LECCI's asset liquidity was relatively weak, as it has a large size of inventories and intangible asset (mainly construction costs, land use rights and other operating franchise), which together amounted to RMB7.9 billion at end-September 2023, representing 55.2% of total asset. The company's inventories usually take a long time to monetize due to the protracted construction and payment collection period. In addition, the company had a large amount of investment properties (mainly for rental purpose and self-operation in the industrial parks it developed), which accounted for 10.6% of total asset.

Debt Servicing Capability

The liquidity of LECCI was sufficient. At end-September 2023, LECCI had a cash balance and unused credit facilities of RMB1.5 billion and RMB4.3 billion, respectively, compared with its debt due within one year of RMB1.0 billion. Besides, LECCI has access to various financing channels, including bank loans and non-traditional financing, to support its debt repayment and business operations.

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