

Longkou Gangcheng Investment Development and Construction Group Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BBB+
Outlook	Stable
Location	China
Industry	Local Investment and Development Companies
Date	19 January 2024

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

Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of Longkou City (“Longkou government”) would provide very strong support to LKGI if needed, in light of its full ownership of LKGI, LKGI’s strategic importance as sole local investment and development company (“LIDC”) responsible shantytown renovation and an important infrastructure development entity in Longkou City (“Longkou”), and the linkage between the Longkou government and LKGI, including appointment of the senior management, strategic alignment, supervision of major investment and financing plan decisions and ongoing operational and financial support. In addition, the Longkou government may face significant negative impact on its reputation and financing activities if LKGI encounters any operational and financial difficulties.

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

Rating Rationale

Longkou Government’s Ownership and Supervision: The Longkou government holds 100% ownership of LKGI through the Longkou State-owned Assets Operation and Support Center (“Longkou SAOSC”). As the ultimate controller of LKGI, Longkou government has strong control and supervision over the company, including management appointment, decision on its strategic development and investment plan and supervision of its major funding decisions. In addition, the Longkou government has assessment mechanism over the company through Longkou SAOSC and appoints auditors to supervise the operating performance and financials on a periodic basis.

Strategic Importance to Longkou and Strategic Alignment: LKGI is the sole LIDC responsible for shantytown renovation projects of the whole city. It also undertakes infrastructure construction and project development in Longkou High-tech Industrial Park (“LH Industrial Park”), Longkou Economic Development Zone (“Longkou EDZ”) and Longkou Coastal Tourism Resort (“LCT Resort”) to support Longkou’s industrial development. Its business operation and strategic planning have been aligned with the government’s development plans, playing a significant role in promoting the economic and social development of the region.

Ongoing Government Support: LKGI receive ongoing government support in forms of capital/asset injections and financial subsidies to support its business operations, including cash capital injection of RMB2 billion in 2021, asset injections and financial subsidies amounting to RMB10.2 billion and RMB700 million, respectively, between 2020 and the first nine months of 2023. We believe that the government support will remain intact given the company’s strategic importance in Longkou.

Key Figures of Longkou and LKGI

(RMB billion)

	2021	2022
Longkou		
GDP	123.7	138.2
GDP growth rate (%)	9.6	6.0
Budgetary revenue	11.2	11.4
Government fund	1.5	8.4
Transfer payment	2.0	1.8
Budgetary expenditure	10.9	11.5
LKGI	2022	2023.9
Asset	19.4	21.4
Equity	13.6	13.6
Revenue	0.95	0.72

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

Analysts

Karis Fan, CESGA
 (852) 3462 9579
karis.fan@lhratingsglobal.com

Roy Luo, FRM, CESGA
 (852) 3462 9582
roy.luo@lhratingsglobal.com

Applicable Criteria

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

Economy and Fiscal Condition of Longkou: Longkou is a county-level city directly under the jurisdiction of Shandong Province and managed by Yantai city. As one of the top 100 counties in China in terms of comprehensive strength, Longkou maintained a stable economic growth in the past three years. Longkou's GDP reached RMB138.2 billion in 2022, representing a year over year growth rate of 6.0%. Its economic development focused on machinery, non-ferrous metal smelting and rolling, chemicals, building materials and food industry in recent years.

The Longkou government's aggregate fiscal revenues are mainly derived from budgetary revenue, which increased to RMB11.4 billion in 2022 from RMB10.2 billion in 2020. Its fiscal self-sufficiency capacity is moderate, with a budget deficit of 0.9% in 2022. Longkou's government fund income, mainly generated by land sales, increased from RMB1.5 billion in 2021 to RMB8.4 billion in 2022, owing to the large increase of land sales incomes.

The outstanding debt of the Longkou government increased to RMB18.8 billion at end-2022 from RMB13.5 billion at end-2021, mainly due the increase of special debt to support Longkou's project development.

LKGI's Financial and Liquidity Position: LKGI's total asset surged to RMB21.4 billion at end-September 2023 from RMB11.6 billion at end-2020, as the company actively participated in Longkou's project development. The company relied on both borrowings and capital injections from the local government to fund its asset expansion. Its total debt reached RMB6.7 billion at end-September 2023, up from RMB677 million at end-2020. The company's financial leverage, as measured by debt/capitalization increased to 33.6% from 6.3% over the same period. We expect LKGI to continue to rely on external financing to support its capital expenditures and debt repayments.

LKGI's asset quality was relatively weak. By end-September 2023, the company had accumulated sizeable inventories of RMB9.3 billion (mainly construction costs and lands to be developed) from its infrastructure construction and shantytown renovation projects. These inventories usually take a long time to monetize due to protracted construction, recognition and cash collection periods. At the same time, the company also had investment properties amounting to RMB3.7 billion, which mainly comprised its self-operated industrial projects. Yet LKGI is still applying ownership certification for part of investment properties.

LKGI's short-term debt servicing pressure is manageable. At end-September 2023, LKGI had unrestricted cash balance of RMB295 million, compared with its debt due within one year of RMB300 million. In addition, LKGI has accessed to various financing channels, including bank loans, bond issuance and non-traditional financing, to support its debt repayments and business operations. At end-September 2023, the company had unused credit facilities amounting to RMB1.8 billion.

Rating Sensitivities

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

We would consider upgrading LKGI 's rating if there is an upgrade in our internal credit assessment on the Longkou government.

Operating Environment

Economic Condition of Longkou

Longkou is a county-level city directly under the jurisdiction of Shandong Province and managed by Yantai city. Longkou is located on the northwest part of Jiadong Peninsula, bordering the Bo Sea in the north, with a total area of 901 square kilometers. Longkou owns one provincial economic development zone, one high-tech industrial zone and one coastal resort area. According to the 7th national census, Longkou had a resident population of 0.7 million, with an urbanization rate of 70.7%.

As one of the top 100 counties in China in terms of comprehensive strength, Longkou maintained a stable economic growth in the past three years. Longkou's GDP reached RMB138.2 billion in 2022, representing a year over year growth rate of 6.0%, and its GDP scale was ranked 2nd among 11 districts and counties of Yantai. GDP per capita of Longkou was RMB189,400 in 2022, which was well above the GDP per capita of Yantai (RMB134,600) and China (RMB85,700).

Longkou's economic growth was mainly fueled by the secondary and tertiary industries, which accounted for 49.1% and 47.7% in 2022, respectively. Its economic development focused on machinery, non-ferrous metal smelting and rolling, chemicals, building materials and food industry in recent years.

Longkou's GDP and Fixed Asset Investment

(RMB billion)	2020	2021	2022
GDP	109.4	123.7	138.2
-Primary industry (%)	3.3	3.3	3.2
-Secondary industry (%)	48.3	48.6	49.1
-Tertiary industry (%)	48.4	48.1	47.7
GDP growth rate (%)	5.3	9.6	6.0
Fixed asset investment growth rate (%)	6.4	13.0	11.5
Population (million)	0.7	0.7	0.7

Source: Public information and Lianhe Global's calculations

Fiscal Condition of Longkou

The Longkou government's aggregate fiscal revenues are mainly derived from budgetary revenue, which increased to RMB11.4 billion in 2022 from RMB10.2 billion in 2020. Its fiscal self-sufficiency capacity is moderate, with a budget deficit of 0.9% in 2022 following a budget surplus of 2.3% in 2021. On the other hand, Longkou's government fund income, mainly generated by land sales, increased from RMB1.5 billion in 2021 to RMB8.4 billion in 2022, owing to the large increase of land transfers. However, we do not expect this trend to continue given current weak property market.

The outstanding debt of the Longkou government increased to RMB18.8 billion at end-2022 from RMB13.5 billion at end-2021, mainly due the increase of special debt to support Longkou's project development. Its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 91.6% at end-2021 from 79.0% at end-2020, and dropped slightly to 86.6% at end-2022, mainly due to the increase in aggregate revenue.

Longkou's Fiscal Condition

(RMB billion)	2020	2021	2022
---------------	------	------	------

Budgetary revenue	10.2	11.2	11.4
Budgetary revenue growth rate (%)	1.1	9.7	1.6
Tax revenue	6.3	8.4	7.9
Tax revenue (% of budgetary revenue)	61.9	75.2	69.4
Government fund income	1.1	1.5	8.4
Transfer payment	2.3	2.0	1.8
Aggregate revenue	13.7	14.7	21.7
Budgetary expenditure	10.8	10.9	11.5
Budget balance ¹ (%)	-5.8	2.3	-0.9

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

Source: Public information and Lianhe Global's calculations

Ownership Structure

Government's Ownership

LKGI was established in September 2013 with an initial registered capital of RMB5 million. After an array of capital injections, the company's registered and paid-in capital increased to RMB2.5 billion and RMB2.0 billion at end-2022, respectively. The Longkou government, as the ultimate controller, holds 100% shares of LKGI through Longkou SAOSC.

Strategic Importance and Government Linkage

Strategic Importance of LKGI to Longkou

LKGI is the sole LIDC responsible for shantytown renovation projects in the whole city. It also undertakes infrastructure construction and project development in the LH Industrial Park, Longkou EDZ and LCT Resort to support Longkou's industrial development. Its business operation and strategic planning have been aligned with the government's development plans, playing a significant role in promoting the economic and social development of the region.

Strong Linkage with the Local Government

LKGI's linkage with the local government is strong as the Longkou government holds 100% ownership of LKGI through the Longkou SAOSC. The Longkou government has strong control and supervision over the company, including management appointment, decision on its strategic development and investment plan and supervision of its major funding decisions. In addition, the Longkou government has assessment mechanism over the company through Longkou SAOSC and appoints auditors to supervise the operating performance and financials on a periodic basis.

Ongoing Government Support

LKGI receive ongoing government support in forms of capital/asset injections and financial subsidies to support its business operations. We believe that the government support will remain intact given the company's strategic importance in Longkou.

The local government injected cash capital of RMB2,000 million into LKGI in 2021, enlarging its paid-in capital to RMB2,005 million from RMB5 million. Between 2020 and the Meanwhile, the company received RMB10.2 billion worth of assets, such as construction projects, sea area right, commercial center and equity of local state-owned enterprises, from the local

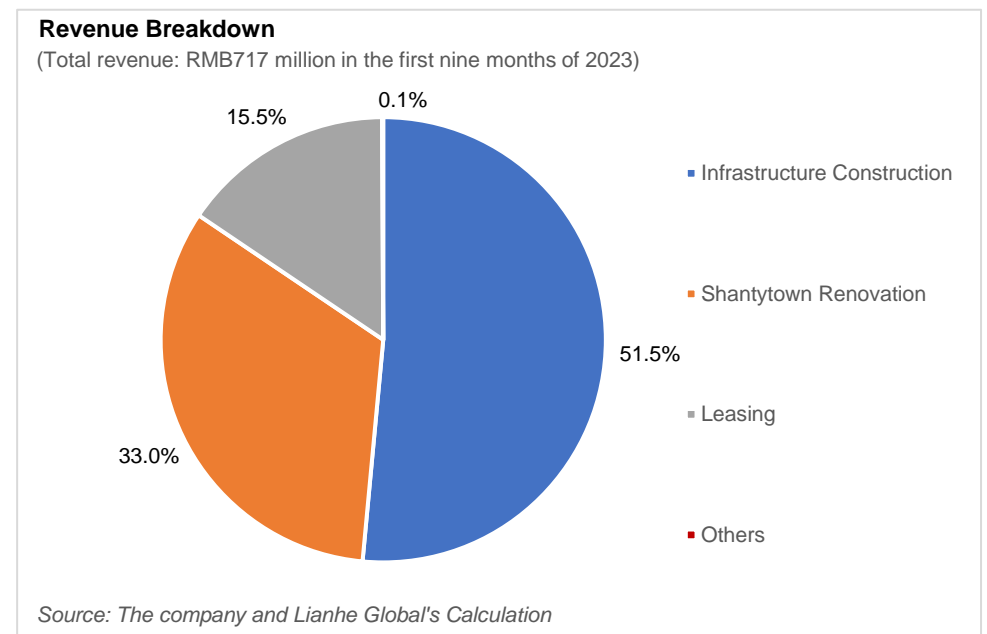
government. The local government provided financial subsidies amounting to RMB700 million over the same period to LKGI to support its activities in relation to shantytown renovation project.

Business Profile

The Sole Entity Responsible for Shantytown Renovation in Longkou

LKGI is the sole LIDC in Longkou responsible for shantytown renovation projects of the whole city, and undertakes infrastructure construction and project development in the LH Industrial Park, Longkou EDZ and LCT Resort, with strong regional franchises advantages.

The primary sources of operating revenue for LKGI are infrastructure construction and shantytown renovation, while it also engaged in leasing business. The company realized total revenue of RMB669 million, 700 million, 953 million and 717 million in 2020, 2021, 2022 and the first nine months of 2023, respectively, showing a steady upward trend, and the overall gross profit margin of LKGI stayed between 12.2% and 12.6%.



Shantytown Renovation

LKGI is the sole entity authorized by the Longkou government to undertake shantytown renovation projects in Longkou. The company is responsible for preparation, investment and financing management, as well as construction management of shantytown renovation projects in Longkou. The project funds are from the company's own funds, external financing and government subsidies, etc. Longkou Housing Construction Bureau usually repurchase these projects at the construction costs plus a 15% of profit upon completion. The company also recoups investments through selling resettlement houses to relocation households, selling residential and commercial properties, as well as leasing and operating incomes.

Infrastructure Construction

LKGI undertake construction projects in the LH Industrial Park, Longkou EDZ and LCT Resort of Longkou, including infrastructure development, land consolidation, road construction, etc. According to signed agreements, LKGI handles fundraising and construction for relevant projects, then entrusting party repurchase these projects in batches at the price of the construction costs plus a certain percentage of profit (generally 15%).

LKGI also develops self-operated industrial parks projects, aiming to obtain operational and rental incomes after completion. By end-2022, the company had two self-operated projects under construction, with total planned investment of RMB8.4 billion. This could bring high capital expenditure pressure on LKGI in the next two to three years.

Leasing Business

LKGI engages in leasing business, which mainly involves the leasing of pipe gallery and the sea area right. These assets were mainly injected by the Longkou government, and the company leases them and receives rental payments. This segment mainly plays the role of supplementing the revenue of the main business and makes the revenue structure more diversified.

Financial Profile

Balance Sheet Structure and Quality

Balance Sheet Structure and Quality				
(RMB million)	2020	2021	2022	September 2023
Total Asset	11,603	16,982	19,392	21,443
Equity	10,019	13,347	13,576	13,597
Debt	677	2,192	5,111	6,746
Debt / (Debt + Equity) (%)	6.3	14.1	27.4	33.2
LT Debts	677	1,143	4,501	6,446
LT Debt / (LT Debt + Equity) (%)	6.3	7.9	24.9	32.2

Source: Company information and Lianhe Global's calculations

LKGI's total asset surged to RMB21.4 billion at end-September 2023 from RMB11.6 billion at end-2020, as the company actively participated in Longkou's project development. The company relied on both borrowings and capital injections from the local government to fund its asset expansion.

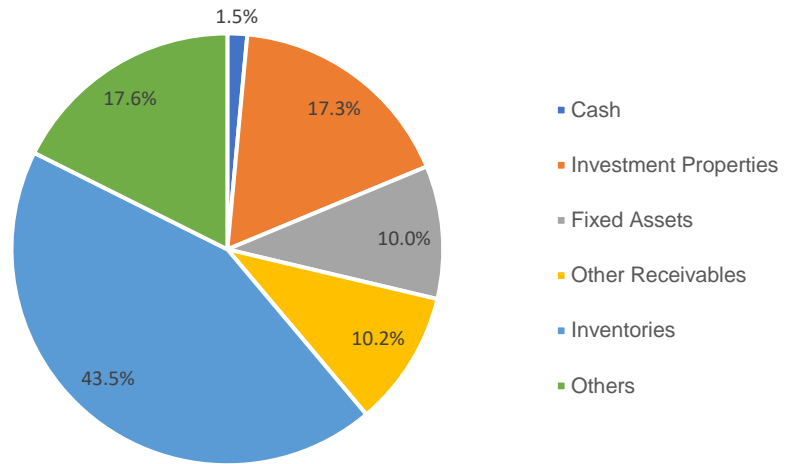
LKGI's total debt reached RMB6.7 billion at end-September 2023, almost tenfold compared with RMB677 million at end-2020. The company's financial leverage, as measured by debt/capitalization increased to 33.6% at end-September 2023 from 6.3% at end-2020. Yet it remained at a manageable level. We expect LKGI to continue to rely on external financing to support its capital expenditures and debt repayments.

LKGI's asset quality was relatively weak. By end-September 2023, the company had accumulated sizeable inventories of RMB9.3 billion (mainly construction costs and lands to be developed) from its infrastructure construction and shantytown renovation projects. These inventories usually take a long time to monetize due to protracted construction, recognition and cash collection periods. The company also had investment properties amounting to RMB3.7 billion, which mainly comprised its self-operated industrial parks projects. Yet LKGI is still applying ownership certification for part of investment properties.



Asset Breakdown

(Total Assets:RMB21.4 billion at end-September 2023)



Source: The company and Lianhe Global's Calculation

Debt Servicing Capability

LKGI's short-term debt servicing pressure is manageable. At end-September 2023, LKGI had unrestricted cash balance of RMB295 million, compared with its debt due within one year of RMB300 million. In addition, LKGI has accessed to various financing channels, including bank loans, bond issuance and non-traditional financing, to support its debt repayments and business operations. At end-September 2023, the company had unused credit facilities amounting to RMB1,893 million.

Disclaimer

Credit rating and research reports published by Lianhe Ratings Global Limited (“Lianhe Global” or “the Company” or “us”) are subject to certain terms and conditions. Please read these terms and conditions at the Company’s website: www.lhratingsglobal.com

A credit rating is an opinion addresses the creditworthiness of an entity or security. Credit ratings are not a recommendation to buy, sell, or hold any security. Credit ratings do not address market price, marketability, and/or suitability of any security nor its tax implications or consequences. Credit ratings may be subject to upgrade or downgrade or withdrawal at any time for any reason at the sole discretion of Lianhe Global.

All credit ratings are the products of a collective effort by accredited analysts through rigorous rating processes. No individual is solely responsible for a credit rating. All credit ratings are derived by credit committee vesting processes. The individuals identified in the reports are solely for contact purpose only.

Lianhe Global conducts its credit rating services based on third-party information which we reasonably believe to be true. Lianhe Global relies on information including, but not limited to, audited financial statements, interviews, management discussion and analysis, relevant third-party reports, and publicly available data sources to conduct our analysis. Lianhe Global has not conducted any audit, investigation, verification or due diligence. Lianhe Global does not guarantee the accuracy, correctness, timeliness, and/or completeness of the information. Credit ratings may contain forward-looking opinions of Lianhe Global which may include forecasts about future events which by definition are subject to change and cannot be considered as facts.

Under no circumstance shall Lianhe Global, its directors, shareholders, employees, officers and/or representatives or any member of the group of which Lianhe Global forms part be held liable to any party for any damage, loss, liability, cost, expense or fee in connection with any use of the information published by the Company.

Lianhe Global receives compensation from issuers, underwriters, obligors, or investors for conducting credit rating services. None of the aforementioned entity nor its related party participate in the credit rating process aside from providing information requested by Lianhe Global.

Credit ratings included in any rating report are solicited and disclosed to the rated entity (and its agents) prior to publishing. Credit rating and research reports published by Lianhe Global are not intended for distribution to, or use by, any person in any jurisdiction where such use would infringe local laws and regulations. Any user relies on information available through credit rating and research reports is responsible for consulting the relevant agencies or professionals accordingly to comply with the applicable local laws and regulations.

All published credit rating and research reports are the intellectual property of Lianhe Global. Any reproduction, redistribution, or modification, in whole or parts, in any form by any means is prohibited unless such user has obtained prior written consent from us.

Lianhe Global is a subsidiary of China Lianhe Credit Rating Co., Ltd. The credit committee of Lianhe Global has the ultimate power of interpretation of any methodology or process used in the Company’s independent credit ratings and research.

Copyright © Lianhe Ratings Global Limited 2024.