

Haiyang State-owned Capital Operation Group Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BBB
Outlook	Stable
Location	China
Industry	Local Investment and Development Companies
Date	9 February 2024

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

Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of Haiyang City, Yantai City (“Haiyang government”) would provide very strong support to HSCOG if needed, in light of its full ownership of HSCOG, HSCOG’s strategic importance as the sole local investment and development company (“LIDC”) that is responsible for infrastructure construction and shantytowns renovation in Haiyang County, Yantai City (“Haiyang”), and the linkage between the Haiyang government and HSCOG, 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 Haiyang government may face significant negative impact on its reputation and financing activities if HSCOG encounters any operational and financial difficulties.

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

Rating Rationale

Haiyang Government’s Ownership and Supervision: The Haiyang government holds the full ownership of HSCOG through the Finance Bureau of Haiyang County (“Haiyang FB”). The Haiyang 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 Haiyang 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 Haiyang and Strategic Alignment: HSCOG, as the key LIDC in Haiyang, is primarily responsible for the investment, development and operation of infrastructure projects and shantytowns renovation projects within the city. Serving as the sole entity in charge of infrastructure projects throughout the region, HSCOG is mainly engaged in urban renewal, road construction and upgrading and other infrastructure related projects with strong regional advantages. It is also entrusted with the function of industrial investment and tourism development in Haiyang. HSCOG 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: HSCOG received operational and financial support from the Haiyang government. HSCOG received a total subsidy amount of RMB297.8 million from 2020 to the first nine months of 2023. The Haiyang government continued to inject capital, project-related assets, right of use assets, equities of other companies and other kinds of assets into HSCOG to expand its asset size and diversify its business. Besides, the Haiyang government will repurchase some infrastructure projects and provide policy supports to HSCOG to ensure its business operation. Given that it is the sole entity for infrastructure

Key Figures of Haiyang and HSCOG

(RMB billion)	2021	2022
Haiyang		
GDP	46.0	49.8
GDP growth rate (%)	6.0	4.5
Budgetary revenue	3.1	3.0
Government fund	2.6	2.6
Transfer payment	1.5	1.7
Budgetary expenditure	4.4	4.6
HSCOG	2022	2023.9
Assets	30.5	30.8
Equity	18.1	18.4
Revenue	1.6	1.8

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

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Applicable Criteria

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

construction and shantytown renovation in Haiyang, HSCOG has an advantage in acquiring related resources and major projects. We believe HSCOG is likely going to receive government support to support its daily business operation.

HSCOG's Financial Matrix and Liquidity Position: HSCOG's total assets showed a continuous growth trend in the past few years and reached RMB30.8 billion at end-September 2023, largely attributed to the increase of inventories that related to the company's infrastructure construction business. The current assets of HSCOG accounted for 61.2% of the total assets at end-September 2023, yet the overall asset liquidity was moderately weak due to large amount of inventories and receivables. HSCOG's financial leverage (total liabilities to total assets) declined to 40.4% and its adjusted debt decreased to RMB8.5 billion at end-September 2023 from RMB8.7 billion at end-2022. The liquidity of HSCOG was tight. At end-September 2023, HSCOG had a cash balance and unused credit facilities of RMB1.8 billion and RMB607.4 million, respectively, compared with its debt due within one year of RMB2.5 billion. Having said that, HSCOG has access to various financing channels, including bank loans and non-traditional financing, to support its debt repayment and business operations.

Economy and Fiscal Strength of Haiyang: Haiyang is a county-level city of Yantai City, Shandong Province, and is located in the southern end of Jiaodong Peninsula. Haiyang's economic growth fluctuated in the past three years due to the COVID-19 pandemic, with a year-over-year growth rate of -1.5%, 6.0% and 4.5% in 2020, 2021 and 2022, respectively. Haiyang's GDP reached RMB49.8 billion in 2022, and ranked the 7th among all districts and county-level cities under the administration of Yantai. The Haiyang government's aggregate fiscal revenues are mainly derived from budgetary income and government fund income. The Haiyang government's budgetary revenue decreased to c. RMB3.0 billion in 2022 from c. RMB3.1 billion in 2021. In contrast, its budgetary expenditure increased to RMB4.6 billion in 2022 from RMB4.4 billion in 2021. Therefore, the Haiyang government's budget deficit was enlarged to -52.3% over the same period. The debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 160.6% at end-2022 from 125.4% at end-2020, mainly due to the increase in special debt.

Rating Sensitivities

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

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

Operating Environment

Economic Condition of Haiyang

Haiyang is a county-level city of Yantai City, Shandong Province, and is located in the southern end of Jiaodong Peninsula. Haiyang has jurisdiction over 18 towns and streets, with a land area of 1,909 square kilometers and a sea area of 1,829 square kilometers. Besides, it owns one national tourism resort, one provincial economic development zone, and one provincial industrial park. At end-2020, Haiyang had a resident population of c. 0.6 million, with an urbanization rate of 50.3%.

Haiyang's economic growth fluctuated in the past three years due to the COVID-19 pandemic, with a year-over-year growth rate of -1.5%, 6.0% and 4.5% in 2020, 2021 and 2022, respectively. Haiyang's GDP reached RMB49.8 billion in 2022, and ranked the 7th among all districts and county-level cities under the administration of Yantai. Haiyang's economic growth was mainly fueled by the secondary and tertiary industries in the past few years, which accounted for 35.6% and 44.5% in 2022, respectively. Apart from traditional industries like sweater production and equipment manufacturing, Haiyang focused on the development of marine engineering, IT, biochemical engineering, automobile, nuclear and wind power, aerospace industry in recent years.

Haiyang's GDP and Fixed Asset Investment			
(RMB billion)	2020	2021	2022
GDP	42.0	46.0	49.8
-Primary industry (%)	19.9	19.8	19.9
-Secondary industry (%)	33.4	34.0	35.6
-Tertiary industry (%)	46.7	46.2	44.5
GDP growth rate (%)	-1.5	6.0	4.5
Fixed asset investment	56.0	52.1	54.2
Fixed asset investment growth rate (%)	0.1	-7.0	4.0
Population (million)	0.6	0.6	0.6

Source: Public information and Lianhe Global's calculations

Fiscal Condition of Haiyang

The Haiyang government's aggregate fiscal revenues are mainly derived from budgetary income and government fund income. The Haiyang government's budgetary revenue decreased to c. RMB3.0 billion in 2022 from c. RMB3.1 billion in 2021, due to the large-scale value-added tax credit refunds to support the economy. In contrast, its budgetary expenditure increased to RMB4.6 billion in 2022 from RMB4.4 billion in 2021. Therefore, the Haiyang government's budget deficit was enlarged to -52.3% over the same period. Meanwhile, Haiyang's government fund income and transfer payment remained relatively stable in 2022, recording at RMB2.6 billion and RMB1.7 billion, respectively.

The debt ratio of the Haiyang government was high. At end-2022, the Haiyang government's outstanding debt was c. RMB11.8 billion, including c. RMB6.9 billion of general obligations and c. RMB4.8 billion of special debt. The debt ratio, as measured by total government debt outstanding/aggregate revenue, had increased to 160.6% at end-2022 from 125.4% at end-2020, mainly due to the increase in special debt.

Haiyang's Fiscal Condition			
(RMB billion)	2020	2021	2022
Budgetary revenue	3.0	3.1	3.0
Budgetary revenue growth rate (%)	7.0	3.2	6.3*
Tax revenue	1.5	2.0	1.6
Tax revenue (% of budgetary revenue)	50.6	65.5	54.0
Government fund income	1.4	2.6	2.6
Transfer payment	1.9	1.5	1.7
Aggregate revenue	6.3	7.2	7.3
Budgetary expenditure	4.5	4.4	4.6
Budget balance ¹ (%)	-48.0	-42.4	-52.3

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

HSCOG was established in May 2013 with an initial registered capital of RMB2.0 billion, funded by Haiyang FB. After a series of asset transfers, at end-September 2023, HSCOG had a shareholding structure in which the Haiyang Finance Bureau, as the solo shareholders and actual controller, held 100% of the company's equity, with the registered and paid-in capital recording at RMB2.0 billion and RMB1.472 billion, respectively.

Strategic Importance and Government Linkage

Strategic Importance of HSCOG to Haiyang

HSCOG, as the key LIDC in Haiyang, is primarily responsible for the investment, development and operation of infrastructure projects and shantytowns renovation projects within the city. Serving as the sole entity in charge of infrastructure projects throughout the region, HSCOG is mainly engaged in urban renewal, road construction and upgrading and other infrastructure related projects with strong regional advantages. It is also entrusted with the function of industrial investment and tourism development in Haiyang. HSCOG 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

HSCOG's linkage with the local government is strong as the Haiyang government holds the full ownership of HSCOG through Haiyang FB. The Haiyang 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 Haiyang 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

HSCOG received operational and financial support from the Haiyang government. HSCOG received a total subsidy amount of RMB297.8 million from 2020 to the first nine months of 2023. The Haiyang government continued to inject capital, project-related assets, right of use assets, equities of other companies and other kinds of assets into HSCOG to expand its asset size and diversify its business. Besides, the Haiyang government will repurchase some infrastructure projects and provide policy supports to HSCOG to ensure its business operation. Given that it is the sole entity for infrastructure construction and shantytown renovation in Haiyang, HSCOG has an advantage in acquiring related resources and major projects. We believe HSCOG is likely going to receive government support to support its daily business operation.

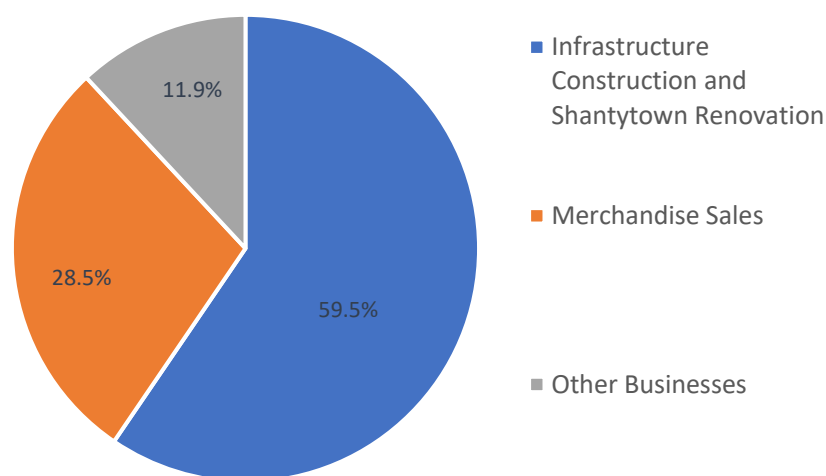
Business Profile

The Sole Entity Responsible for Infrastructure Construction in Haiyang

HSCOG, as an important LIDC in Haiyang, is mainly responsible for infrastructure construction and shantytown renovation within the region. The primary sources of operating revenue for HSCOG are infrastructure construction and shantytown renovation, while it also engaged in merchandise sales, tourist attractions, hotels, advertising, catering, cultural and creative products, etc. The company's total revenue continued increased to RMB1.6 billion in 2022, up from RMB0.8 billion in 2020. The overall gross profit margin of HSCOG kept increased, with 3.6%, 9.7% and 10.0% in 2020, 2021 and 2022, respectively. In general, HSCOG's business was relatively concentrated, and it has regional advantages in its major businesses.

Revenue Breakdown

(Total revenue: RMB1.6 billion in 2022)



Source: The company and Lianhe Global's Calculation

Infrastructure Construction and Shantytown Renovation

HSCOG undertakes infrastructure construction and shantytown renovation within Haiyang, with a strong regional franchise advantage. Infrastructure construction mainly involves the construction of municipal roads, education and medical infrastructures, water projects, etc. The company signs the agent construction agreements with the entrusting party and is responsible for fundraising and construction of entrusted projects. The company settles construction costs plus a percentage (c.10~15%) of management fees annually with the entrusting party according to the project's progress.

The company entrusts Haiyang Haohai Urban Development and Construction Group Co., Ltd. ("HUDC"), as a subsidiary of the company, to undertake shantytown renovation business, which is mainly conducted under two models: new construction resettlement model and procurement placement model. New construction resettlement model mainly involves demolition, land leveling and construction of resettlement houses before started, with 20% of project construction fund raised by the Haiyang Finance Bureau and the remaining 80% borrowed from policy banks. Under procurement placement model, the company signs an agreement with third-party real estate developers to purchase some properties for resettlement, and settles the purchase cost plus a percentage of profits with Haiyang Finance Bureau annually according to the resettlement process.

The revenue of this segment reached surged to c. RMB1.0 billion in 2021 from RMBRMB0.3 billion in 2020, and remained relatively stable in 2022. Its gross profit margin in this segment increased to 12.7% in 2022 from 7.6% in 2020. Currently, the company's projects under construction and to be constructed still require a large scale of investment, thus it incurs high pressure on capital expenditure.

Merchandise Sales

HSCOG is mainly engaged in the sales of grain and oil, stone, minerals, etc. The revenue generated from this segment was volatile in the past few years, recording at c. RMB373 million, RMB41 million and RMB470 million in 2020, 2021 and 2022, respectively. The gross profit margin of the segment was on an upward trend, increasing from 7.6% to 13.0% over the same period.

Other Businesses

Other businesses of HSCOG include tourist attractions, hotels, advertising, catering, cultural and creative products etc., with each segment accounting 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	September-2023
Total Asset	12,482	25,552	30,508	30,800
Equity	5,491	16,914	18,121	18,364
Debt	4,934	6,440	8,688	8,490
Debt / (Debt + Equity) (%)	47.3	27.6	32.4	31.6
LT Debt	4,643	5,167	5,858	5,979
LT Debt / (LT Debt + Equity) (%)	45.8	23.4	24.4	24.6

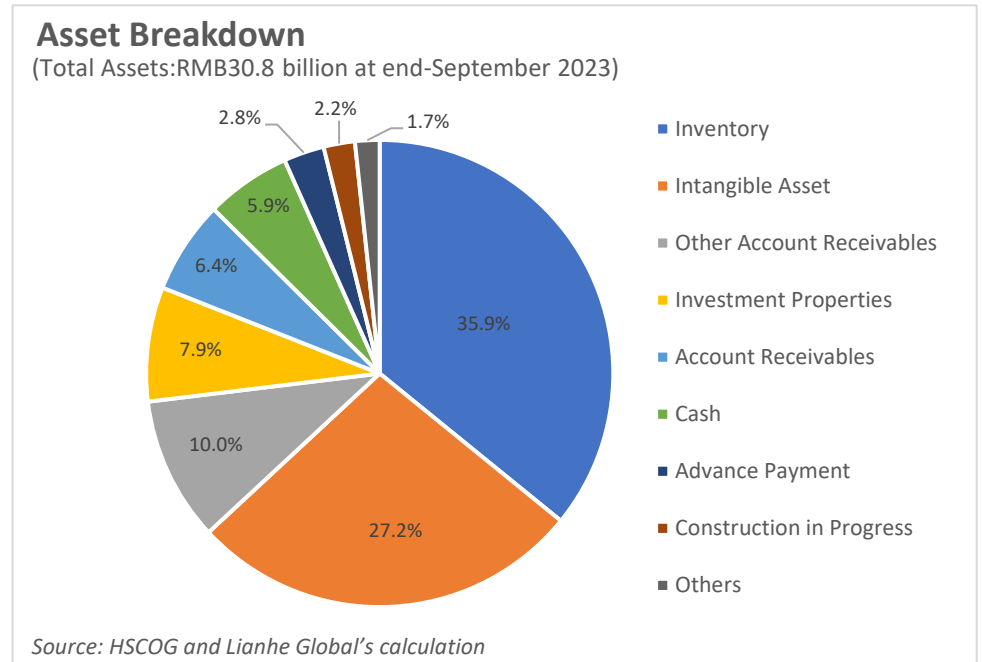
Source: Company information and Lianhe Global's calculations

HSCOG's asset size grew rapidly to RMB30.8 billion at end-September 2023 from RMB12.5 billion at end-2020, largely attributed to the increase of inventory. The company's financial leverage, as measured by debt/capitalization declined to 31.6% at end-September 2023 from 47.3% at end-2020. However, its debt structure was weakening, with long-term debt's proportion decreasing to 70.4% at end-September 2023 from 80.2% at end-2020. Having said that, the total adjusted debt decreased to RMB8.5 billion at end-September 2023 from RMB8.7 billion at end-2022.

HSCOG's asset liquidity was moderately weak, as it has a large part of inventories, intangible asset and account receivables. The company's project construction activities accumulated sizeable inventories (mainly lands and construction costs), investment properties and construction in progress, which added up to RMB14.2 billion, representing 45.9% of total asset at end-September 2023. These assets usually take a long time to monetize due to the protracted construction and payment collection period. Intangible asset of the company recorded at RMB8.4 billion, and representing 27.2% of total asset at end-September 2023. In addition, the company had a large number of account receivables and other account receivables (primarily due from government agencies), together representing



16.4% of total asset at end-September 2023. Their repayment schedules are highly subject to the fiscal conditions of the local government.



Debt Servicing Capability

HSCOG's liquidity is tight. At end-September 2023, HSCOG had a cash balance and unused credit facilities of RMB1.8 billion and RMB607.4 million, respectively, compared with its debt due within one year of RMB2.5 billion. Having said that, HSCOG 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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