

Lunan (Zaozhuang) Economic Development Investment Co., Ltd.

Initial Issuer Report

Summary

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

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned ‘BBB’ global scale Long-term Issuer Credit Rating with Stable Outlook to Lunan (Zaozhuang) Economic Development Investment Co., Ltd. (“LEDI” or “the company”)

Summary

The Issuer Credit Rating reflects a high possibility that the People’s Government of Zaozhuang City, Shandong Province (“Zaozhuang government”) would provide strong support to LEDI if needed, in light of its full ownership of LEDI, LEDI’s strategic importance as the key local investment and development company (“LIDC”) that is responsible for infrastructure construction and state-owned asset operation in Zaozhuang City, Tai’an City (“Zaozhuang”), and the linkage between the Zaozhuang government and LEDI, 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 Zaozhuang government may face significant negative impact on its reputation and financing activities if LEDI encounters any operational and financial difficulties.

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

Rating Rationale

Zaozhuang Government’s Ownership and Supervision: The Zaozhuang government holds the full ownership of LEDI through the Zaozhuang Administrative State-owned Assets Operation Center’s (“Zaozhuang ASAOC”) fully-owned subsidiary, Lunan Development Investment Holding (Zaozhuang) Group Co. Ltd. (“LDIHG”). The Zaozhuang 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 Zaozhuang 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 Zaozhuang and Strategic Alignment: LEDI, as the key LIDC in Zaozhuang, is primarily responsible for the investment, development and operation of infrastructure projects and supporting facilities within the city. Serving as the key entity in charge of infrastructure projects throughout the region, LEDI is mainly engaged in road, bridge and pipeline projects, industrial park development, healthcare and education projects, and other infrastructure related projects with strong regional advantages. In addition, the company assumes a vital position in various initiatives, including urban renewal, and real estate development projects. LEDI plays an important role in promoting the economic and social development of Zaozhuang. Its business operation and development have been aligned with the government’s development plans.

Ongoing Government Support: LEDI received operational and financial support from the Zaozhuang government. The Zaozhuang government continued to inject capital, project-related assets, properties, equities of other companies and other kinds of assets into LEDI to expand its asset size and diversify its business. Besides, the Zaozhuang government will repurchase some infrastructure projects and provide policy supports to LEDI to ensure its

Key Figures of Zaozhuang and LEDI

(RMB billion)	2022	2023
Zaozhuang		
GDP	203.9	215.7
GDP growth rate (%)	4.5	6.4
Budgetary revenue	16.9	18.1
Government fund	33.7	32.4
Transfer payment	14.5	14.7
Budgetary expenditure	32.6	35.2
LEDI		
	2022	2023.9
Assets	21.0	23.9
Equity	10.7	10.8
Revenue	0.5	0.6

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

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Applicable Criteria

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

business operation. Given that it is the key entity for infrastructure construction and state-owned assets operation in Zaozhuang, LEDI has an advantage in acquiring related resources and major projects. We believe LEDI is likely going to receive government support to support its daily business operation.

LEDI's Financial Matrix and Liquidity Position: LEDI's total assets showed a continuous growth trend in the past few years and reached RMB23.9 billion at end-September 2023, as the company actively participated in the infrastructure construction projects. The current assets of LEDI accounted for 64.3% of the total assets at end-September 2023, yet the overall asset liquidity was moderately weak due to large amount of inventories and investment properties. LEDI's financial leverage (total liabilities to total assets) increased to 55.0% and its adjusted debt increased to RMB7.0 billion at end-September 2023 from RMB1.0 billion at end-2020. LEDI's liquidity was tight. At end-September 2023, LEDI had a cash balance and unused credit facilities of RMB128.5 million and RMB1.0 billion, respectively, compared with its debt due within one year of RMB1.6 billion. Having said that, LEDI has established cooperative relationship with banks to obtain a certain amount of liquidity support and medium- and long-term loans, and it has maintained a normal bank loan financing ability. LEDI also has other financing channels, such as bond issuance and non-traditional financing, to support its debt repayment and business operations.

Economy and Fiscal Strength of Zaozhuang: Zaozhuang is a prefecture-level city of Shandong Province ("Shandong") and is located in the southern part of Shandong. Zaozhuang has jurisdiction over 5 districts, 1 county-level city and 1 national high-tech industrial development zone with a total land area of 4,564 square kilometers. Zaozhuang maintained medium-high economic growth during the past few years, with its GDP growth rate recording 8.3%, 4.5% and 6.4% in 2021, 2022 and 2023, respectively. Zaozhuang's GDP amount reached RMB215.7 billion in 2023, which was mainly driven by the secondary and tertiary industries.

The aggregate fiscal revenue of the Zaozhuang government was mainly derived from budgetary revenue and government fund income. The budgetary revenue of the Zaozhuang government increased steadily to RMB18.1 billion in 2023 from RMB15.9 billion in 2021, while the contribution of tax revenue was reduced to 64.2% from 77.1% over the same period. The financial self-sufficiency of Zaozhuang was weak and continued deteriorating, with the budget deficit widening to 94.4% in 2023 from 72.4% in 2021. The government fund income, mainly originated from land sales revenue, remained relatively stable in the past few years and reached RMB32.4 billion in 2023, accounting for nearly half of the aggregate revenue. The Zaozhuang government's debt expanded rapidly in 2021-2023, mainly due to the rise in special debts. Its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, was elevated to 119.6% at end-2023 from 92.3% at end-2021.

Rating Sensitivities

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

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

Operating Environment

Economic Condition of Zaozhuang

Zaozhuang is a prefecture-level city of Shandong Province (“Shandong”) and is located in the southern part of Shandong. Zaozhuang has a long history, as human beings have lived in the territory of the city as early as 7,300 years ago. Besides, Zaozhuang also has a wealth of coal resources and tourist attractions. Zaozhuang has jurisdiction over 5 districts, 1 county-level city and 1 national high-tech industrial development zone with a total land area of 4,564 square kilometers. At end-2023, Zaozhuang had a residential population of 3.8 million with an urbanization rate of 61.7%.

Zaozhuang maintained medium-high economic growth during the past few years, with its GDP growth rate recording 8.3%, 4.5% and 6.4% in 2021, 2022 and 2023, respectively. Zaozhuang’s GDP amount reached RMB215.7 billion in 2023, which was ranked the last among all Shandong’s jurisdictions. The economic structure of Zaozhuang was mainly driven by the secondary and tertiary industries, which accounted for 38.2% and 52.5% of its GDP in 2023, respectively.

Zaozhuang’s GDP and Fixed Asset Investment			
(RMB billion)	2021	2022	2023
GDP	195.2	203.9	215.7
-Primary industry (%)	9.5	9.5	9.3
-Secondary industry (%)	40.8	39.4	38.2
-Tertiary industry (%)	49.7	51.1	52.5
GDP growth rate (%)	8.3	4.5	6.4
Fixed asset investment	133.4	146.9	157.5
Fixed asset investment growth rate (%)	6.5	10.1	7.2
Population (million)	3.9	3.8	3.8

Source: Public information and Lianhe Global’s calculations

Fiscal Condition of Zaozhuang

The aggregate fiscal revenue of the Zaozhuang government was mainly derived from budgetary revenue and government fund income. The budgetary revenue of the Zaozhuang government increased steadily to RMB18.1 billion in 2023 from RMB15.9 billion in 2021, while the contribution of tax revenue was reduced to 64.2% from 77.1% over the same period. The financial self-sufficiency of Zaozhuang was weak and continued deteriorating, with the budget deficit widening to 94.4% in 2023 from 72.4% in 2021. The government fund income, mainly originated from land sales revenue, remained relatively stable in the past few years and reached RMB32.4 billion in 2023, accounting for nearly half of the aggregate revenue.

The outstanding amount of the Zaozhuang government’s debt expanded rapidly in 2021-2023, mainly due to the rise in special debts. By the end of 2023, the Zaozhuang government’s outstanding debt was RMB79.1 billion, including RMB19.4 billion of general obligations and RMB59.7 billion of special debts. Its fiscal debt ratio, as measured by total government debt outstanding/aggregate revenue, was elevated to 119.6% at end-2023 from 92.3% at end-2021.

Zaozhuang’s Fiscal Condition			
(RMB billion)	2021	2022	2023
Budgetary revenue	15.9	16.9	18.1
Budgetary revenue growth rate (%)	12.9	6.3	7.2
Tax revenue	12.2	11.2	11.6
Tax revenue (% of budgetary revenue)	77.1	66.4	64.2

Government fund income	32.4	33.7	32.4
Transfer payment	11.5	14.5	14.7
Aggregate revenue	60.8	66.0	66.1
Budgetary expenditure	27.4	32.6	35.2
Budget balance ¹ (%)	-72.4	-92.7	-94.4

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

Source: Public information and Lianhe Global's calculations

Ownership Structure

Government's Ownership

LEDI was established in May 2008 with an initial registered capital of RMB400.0 million, funded by Zaozhuang ASAOC. After an array of equity transfers, LDIHG holds whole shares of the company, and the Zaozhuang government is the ultimate controller. The company's registered and paid-in capital was both RMB400.0 million at end-2023.

Strategic Importance and Government Linkage

Strategic Importance of LEDI to Zaozhuang

LEDI, as the key LIDC in Zaozhuang, is primarily responsible for the investment, development and operation of infrastructure projects and supporting facilities within the city. Serving as the key entity in charge of infrastructure projects throughout the region, LEDI is mainly engaged in road, bridge and pipeline projects, industrial park development, healthcare and education projects, and other infrastructure related projects with strong regional advantages. In addition, the company assumes a vital position in various initiatives, including urban renewal, and real estate development projects. LEDI plays an important role in promoting the economic and social development of Zaozhuang. Its business operation and development have been aligned with the government's development plans.

Strong Linkage with the Local Government

LEDI's linkage with the local government is strong as the Zaozhuang government holds the full ownership of LEDI through Zaozhuang ASAOC's fully-owned subsidiary, LDIHG. The Zaozhuang 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 Zaozhuang 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

LEDI received operational and financial support from the Zaozhuang government. The Zaozhuang government continued to inject capital, project-related assets, right-of-use assets, equities of other companies and other kinds of assets into LEDI to expand its asset size and diversify its business. Besides, the Zaozhuang government will repurchase some infrastructure projects and provide policy supports to LEDI to ensure its business operation. Given that it is the key entity for infrastructure construction and state-owned assets operation in Zaozhuang, LEDI has an advantage in acquiring related resources and major projects. We believe LEDI is likely going to receive government support to support its daily business operation.

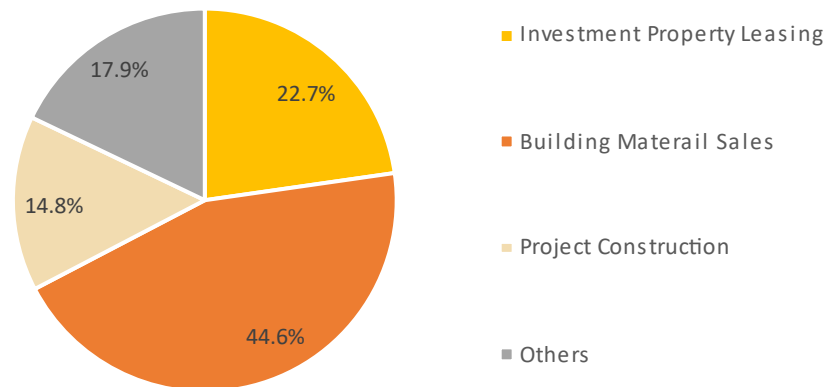
Business Profile

The Key Entity Responsible for Infrastructure Construction in Zaozhuang

LEDI is an important LIDC operating in infrastructure construction, investment property leasing, building material sales and other businesses in Zaozhuang. The primary sources of the company's operating income are project construction, building material sales and investment property leasing, while the company also engages in property sales, project management, doors and windows sales and other businesses. The total operating revenue of LEDI was RMB1,589.7 million, RMB514.4 million, and RMB581.8 million in 2021, 2022 and the first nine months of 2023, respectively. The gross profit margin rose from 7.1% to 31.9% over the same period.

Revenue Breakdown

(Total revenue: c. RMB581.8 million in the first nine months of 2023)



Source: The company and Lianhe Global's calculations

Project Construction

The company's project construction business mainly includes landscaping works, roadworks, construction of Zaozhuang's Center for Disease Control and other infrastructure construction. The infrastructure construction business is operated under both self-construction and agent-construction modes. Under self-construction mode, the projects are constructed with the company's funds and LEDI will operate or lease to others for revenue after being examined. Under agent-construction mode, the company signs Agent Construction Agreements with the entrusting party and is responsible for the preparation, construction and examination of the projects. The settlement of projects under agent-construction mode will be confirmed by the entrusting party according to the actual cost plus a markup after those projects are examined. The income derived from this segment was RMB82.8 million, RMB173.3 million and RMB86.0 million in 2021, 2022 and the first nine months of 2023, respectively. The gross profit margin of this segment ranged between 4.3% and 5.7% over the same period.

Building Material Sales

The building material sales business is conducted under a demand-driven mode and mainly focuses on the steel, tubing and tile trade. This business segment contributes most to the

company's total income. The income derived from the building material sales business was RMB131.7 million, RMB82.6 million and RMB259.5 million in 2021, 2022 and the first nine months of 2023, respectively. The gross profit margin of this segment was low, which fluctuated between 0.6% and 1.7% over the same period.

Investment Property Leasing

The investment property leasing business is operated by the company and its subsidiary Zaozhuang Xinda Property Co., Ltd. ("ZXP"). The company and ZXP separately sign rental agreements with Zaozhuang City Anju Property Management Co., Ltd. and earn rent for income. The property leasing business is another important source of the company's total income and has a high gross profit margin, as the maintenance fees are relatively small. The income derived from this segment was RMB133.2 million, RMB130.6 million and RMB132.2 million in 2021, 2022 and the first nine months of 2023, respectively. The gross profit margin of this segment varied between 91.8% and 99.9% over the same period.

Other Businesses

Except for the businesses mentioned above, the company also engages in other businesses to diversify its business structure, such as property sales, project management, doors and windows sales and other businesses, which have made a good supplement to the company's total revenue.

Financial Profile

Balance Sheet Structure and Quality

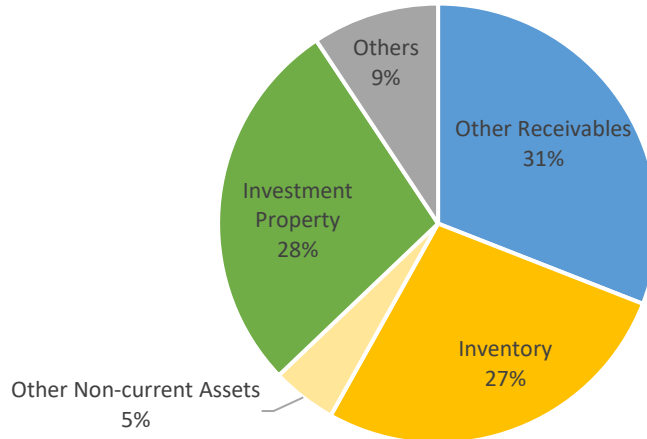
Balance Sheet Structure and Quality				
(RMB million)	2020	2021	2022	September-2023
Total Asset	14,111	16,869	20,968	23,911
Equity	9,889	10,124	10,746	10,750
Debt	1,023	2,829	5,920	6,955
Debt / (Debt + Equity) (%)	9.4	21.8	35.5	39.3
LT Debt	538	2,149	4,238	5,305
LT Debt / (LT Debt + Equity) (%)	5.2	17.5	28.3	33.0

Source: Company information and Lianhe Global's calculations

LEDI's total assets increased steadily to RMB23,911 million at end-September 2023 from RMB14,111 million at end-2020, as the company actively participated in the infrastructure construction projects. Its total debt surged to RMB6,955 million at end-September 2023, more than sixfold compared with that at end-2020 (RMB1,023 million). Both the short-term and long-term debts grew fast in the past few years. At end-September 2023, the short-term debt and long-term debt accounted for 23.7% and 76.3% of the total debt, respectively. The company's financial leverage, as measured by total liability/total asset, elevated from 29.9% to 55.0% over the same period.

Asset Breakdown

(Total Assets:RMB23.91 billion at end-September 2023)



Source: The company and Lianhe Global's calculations

LEDI's asset liquidity was moderately weak. At end-September 2023, the company's assets were dominated by current assets, which accounted for 64.3% of the total assets. The company's project construction activities accumulated sizeable inventories (mainly construction costs) and investment properties, together accounting for 55.0% of total assets at end-September 2023. These assets usually take a long time to monetize due to the protracted construction and payment collection period. In addition, the company had a large number of other receivables, primarily due from government agencies, which accounted for 30.9% of total assets at end-September 2023. Their repayment schedules are highly subject to the fiscal conditions of the local government.

Debt Servicing Capability

LEDI's liquidity was tight. At end-September 2023, LEDI had a cash balance and unused credit facilities of RMB128.5 million and RMB1.0 billion, respectively, compared with its debt due within one year of RMB1.6 billion. Having said that, LEDI has established cooperative relationship with banks to obtain a certain amount of liquidity support and medium- and long-term loans, and it has maintained a normal bank loan financing ability. LEDI also has other financing channels, such as bond issuance and non-traditional financing, to support its debt repayment and business operations.



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