Lianhe Ratings Global

Science City (Guangzhou) Financial Leasing Co., Ltd.

Initial Issuer Report

Summary	
Issuer Rating	BBB
Outlook	Stable
Location	China
Industry	NBFI
Date	16 April 2024

Analysts

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

Roy Luo, FRM
+852 3462 9587
roy.luo@lhratingsglobal.com

Applicable Criteria

Non-Bank Financial Institutions Criteria (21 November 2023)

Lianhe Ratings Global Limited ("Lianhe Global") has assigned 'BBB' global scale Long-term Issuer Credit Rating to Science City (Guangzhou) Financial Leasing Co., Ltd. ("SCFL"); Outlook is Stable

Summary

The Issuer Rating reflects SCFL's franchise in Guangdong's leasing market, especially in Guangzhou's Huangpu District (Guangzhou Development Zone) ("Huangpu District") and Guangzhou Science City ("Science City"), sound business growth and strategy, sufficient capital adequacy and good access to funds, as well as the strong support received from Science City (Guangzhou) Investment Group Co., Ltd. ("SCI Group"), its major shareholder. The rating also considers its concentrated business profile and limited operating scale.

The Stable Outlook reflects our expectation that SCFL will maintain its current market position in the Science City while the SCI Group will continue to ensure SCFL's stable operation.

Rating Rationale

The Key Finance Lease Company in Science City with Strong Market Position and Pivotal Strategic Role: SCFL is a prominent finance leasing entity in Huangpu District, with operations mainly cantered in Science City. It's distinguished by its clear functional distribution, serving the real economy through leasing services. As a subsidiary of the SCI Group, it's pivotal in the local financing leasing industry. Leveraging the SCI Group's advantages, it focuses on Huangpu District, extending to the Pearl River Delta. Its investments cover high-tech sectors like medical, energy conservation, biomedicine, and new-generation IT, fostering synergy between finance and industry for mutual growth and development.

Strong External Support from SCI Group: SCFL would likely receive strong support from SCI Group to ensure its stable operation, considering SCI Group's majority ownership of SCFL, strong integration and linkage, the potential impact on SCI Group's reputation. SCI Group directly and indirectly owns 86.88% shares of SCFL, and SCFL is the only financial lease company under SCI Group. As the majority shareholder, SCI Group has strong control over SCFL, including management appointments and decisions on major investment and funding plans. SCI Group has provided financial guarantees to most of SCFL's debt, significantly increasing SCFL's access to funds.

SCI Group is primarily responsible for project development, industrial investment and city operation within the region. SCI Group received ongoing operational subsidies from the local government in relation to providing public services. The local government also injected assets and cash capital into SCI Group to enhance its equity base. Considering the high strategic importance of SCI Group in promoting economic and social development, and the relatively strong economy and fiscal conditions of Huangpu District (Guangzhou Development Zone), we believe SCI Group's ability to provide support is high.

Sound Business Growth with High Concentration: SCFL, operational since 2017, has experienced steady growth in its leasing business from 2020 to end-September 2023, securing numerous contracts totalling RMB18.7 billion. Yet it slightly decreased due to weakened demand for leasing assets following a decline in bank loan interest rates at end-September

2023. While SCFL maintained relatively good asset quality since its establishment, pandemic-related delays and undesirable financing environment has posed challenges for its credit profile.

SCFL leasing modes include direct, sale and leaseback, and intangible asset leasing, with assets mainly in machinery, equipment, and intangibles. Targeting sectors like consumer goods, electronics, and new energy vehicles, the company provides value-added services and structured financing solutions. However, 88.6% of SCFL's leasing projects are located in Guangdong province at end-September 2023, indicating a high geographical concentration.

Moderately volatile profitability: SCFL maintained stable gross profit margins of 34.5%-40% from 2020 to 2022, but experienced a slight decline in the first nine months of 2023 as the declining bank loan interest rates pressured SCFL’s pricing. The annualized return on equity (“ROE”) showed a downward trend over the same period, from 15.6% in 2020 to 3.04% in 2022 and -0.2% in the first nine months of 2023.

Having said that, the advantageous position of SCFL, stemmed from its strong market foothold in Huangpu, is anticipated to contribute to a favourable and stable profitability trajectory in the future. Besides, as the major finance leasing company in the Science City, the company enjoys a distinct advantage in securing key projects.

Adequate Capital but Moderately Tight Liquidity: SCFL’s capital base strengthened significantly between 2020 and the first nine months of 2023, with paid-in capital growing from RMB300 million to RMB1.3 billion, boosting its capital adequacy ratio from 11.5% to 21.1%. This solid capitalization supports the company’s expansion plans, with leverage standing comfortably below 8x (the regulatory requirement) at 4.34x at end-September 2023. Additionally, SCFL benefits from diverse funding sources, including bank borrowings and asset-backed securities issuance, with financial guarantees from its majority shareholder, the SCI Group.

However, SCFL’s liquidity was moderately tight. At end-September 2023, liquidity assets only covered 17.6% of SCFL’s debts due within one years. Moreover, the company highly relied on short-term fundings, as short-term debts contributed 68.3% of the company, while majority of outstanding leasing had a maturity of two to three years, creating a significant duration mismatch. As a result, SCFL need to frequently refinance its debts and thus subject to the market risks.

Rating Sensitivities

We would consider downgrading SCFL’s rating if there is (1) significant deterioration in its capital adequacy, or (2) notable increase in impaired loans, or (3) weakened funding structure with notable duration mismatch and tightened liquidity, or (4) a significant reduction of SCI Group’s shareholding with weakened operational and financial support from SCI Group’s, or (5) significant deterioration in the access to the bank and/or capital market financings.

We would consider upgrading SCFL’s rating if it were to further improve its 1) franchise with bigger business scale and wider market coverage, 2) funding diversity, 3) capital buffer to support business growth and withstand economic downturn, and 4) strategic alliance with SCI Group with greater business and financial linkages.

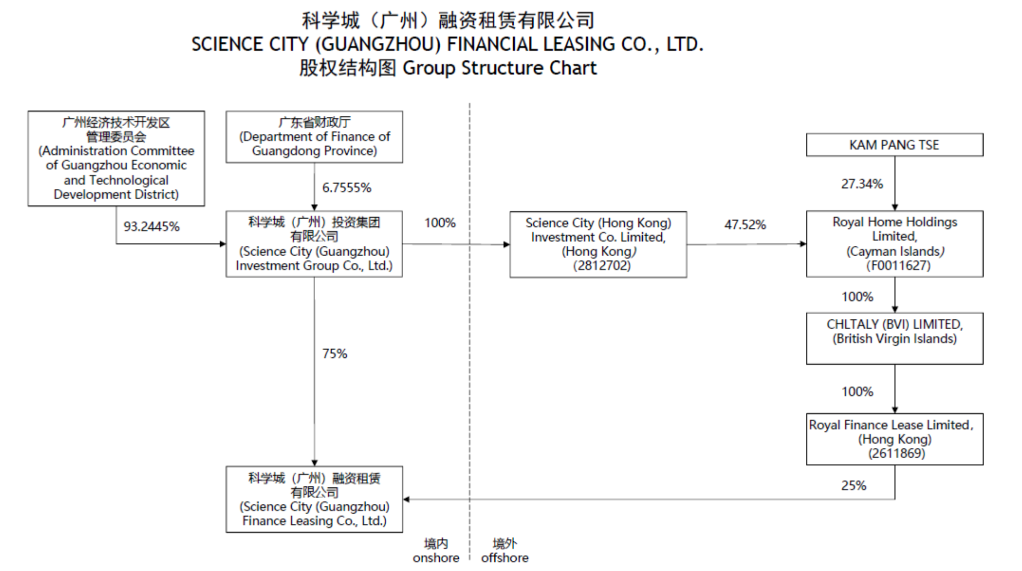
Company Profile

SCFL was established on July 5, 2013, as a Sino-foreign joint venture between Guangdong Zhongkai Investment Co., Ltd. and China Financial Leasing Co., Ltd. The establishment was approved by the Guangzhou Municipal Bureau of Foreign Trade and Economic Cooperation on June 13, 2013. On November 28, 2017, the original equity holder held a shareholders' meeting and agreed to transfer 75% of the company's registered capital, amounting to RMB150 million, from Zhongkai Holdings Group Co., Ltd. to SCI Group.

Subsequently, on September 3, 2020, the shareholders' meeting resolved to transfer 20% of the original equity holder's shares held by China Financial Leasing Co., Ltd. to Comfortable Sofa Co., Ltd. ("CSC") The company's shareholders were then updated, with CSC acquiring 20% ownership, while SCI Group retained its 75% stake, and China Financial Leasing Co., Ltd. held 5%.

Further changes occurred on November 5, 2021, when the shareholder CSC was renamed to Dynasty Financing Leasing Co., Ltd. ("DFL"). Another shareholders' meeting on November 19, 2021, resolved to increase the company's capital, changing its registered capital from RMB600 million to RMB1 billion. Following the capital increase, SCI Group maintained its 75% ownership, while DFL held 23.50%, and China Financial Leasing Co., Ltd. retained 1.50%.

On January 29, 2022, a shareholders' meeting approved the sale of 1.5% of the original equity holder's shares by China Financial Leasing Co., Ltd. to DFL. The company's shareholders were updated accordingly on May 19, 2022, with SCI Group and DFL becoming the sole shareholders, maintaining their respective ownership percentages of 75.0% and 25.0%. The company's paid-in capital was increased to RMB1.3 billion at end-September 2023. The actual controller is the Administration Committee of Guangzhou Economic and Technological Development District.



Source: SCFL

Business Profile

The Key Finance Lease Company in Science City with Strong Market Position and Pivotal Strategic Role

SCFL holds a significant position as a key finance leasing entity within the Huangpu District and the Science City. Its operations are primarily focused within the Science City, distinguishing itself from other financing leasing companies with clear functional distribution. As a subsidiary controlled by the SCI Group, it plays a crucial role in the local financing leasing industry, serving as a key member of the Guangzhou Financing Leasing Industry Alliance. The company has adhered to its core principle of serving the real economy through leasing services. SCFL has provided equipment financing services to numerous enterprises through various models such as sale-and-leaseback and direct leasing within the area.

As an integral part of the SCI Group's financial sector, the company strategically leverages the comprehensive advantages of the group, with a business focus on the Huangpu District, extending its reach across the Pearl River Delta region. Its key industrial investments include high-tech sectors such as medical, energy conservation and environmental protection, biomedicine, high-end equipment manufacturing, new materials, medical devices, and new-generation information technology. By supporting the development of the real economy and facilitating the synergy between finance and industry, the company actively contributes to mutual growth.

Sound Business Growth with High Concentration

SCFL commenced operations in 2017 and has seen a steady increase in leasing activity from 2020 to the first nine months of 2023. During this period, the company secured 101, 156, 154, and 93 new leasing contracts, amounting to RMB2,396.2 million, RMB6,656.1 million, RMB5,453.2 million, and RMB2,053.8 million, respectively.

The company's leasing operations primarily utilize three modes: direct leasing, sale and leaseback, and intangible asset licensing. Its leased assets predominantly consist of machinery, equipment, and intangible assets. SCFL had executed 44 direct leases totaling RMB561.4 million, 535 sale and leaseback contracts totaling RMB17,556.6 million, and 25 intangible asset leases totaling RMB589.5 million in the first nine months of 2023.

SCFL's strategic focus revolves around key industry players, expanding its presence across strategic zones such as Guangzhou Development Zone, Huizhou Zhongkai District, Zhongshan Torch Zone, Zhuhai High-tech Zone, and Zhaoqing High-tech Zone. Targeting sectors like consumer goods, electronics, and new energy vehicles, the company provides value-added services and structured financing solutions. Diversifying into emerging sectors like new energy and education, SCFL leverages its expertise in photovoltaic leasing to explore opportunities in livelihood, new energy vehicle operations, and healthcare, fostering innovation within these industries.

However, 88.6% of SCFL's leasing projects by investment amount are located in Guangdongat end-September 2023. The company's customer base is relatively diversified, with the largest single customer contributing 221.4 million RMB, representing a concentration ratio of 15.1%. Additionally, the top five customers collectively contribute 1 billion RMB. In terms of industry distribution, the intelligent manufacturing sector holds the highest share at 26.5%, while other industries do not exceed 21% as of end-September 2023.

Exhibit 1: SCFL's Revenue Breakdown				
RMB million	**2020**	**2021**	**2022**	**9M2023**
Financing Lease Income	122.7	343.9	521.6	296.3
Financing Factoring	0.4	0.8	0.0	0.0
Fees and Service Charges	67.7	24.6	0.0	1.8
Other Business Income	5.8	0.4	0.6	0.1
Total Income	**196.6**	**369.8**	**522.2**	**298.2**

Source: SCFL and Lianhe Global's calculations

Exhibit 2: Overview of SCFL's Financial Leasing Business				
RMB billion	**2020**	**2021**	**2022**	**9M2023**
Signed Lease Contracts	118	157	154	93
Contract Principal Amount	2.64	7.60	5.72	2.07
Actual Lease Contracts Placed	101	156	154	89
Actual Lease Amount Placed	2.40	6.66	5.45	2.05
Accumulated Lease Amount at End of Period	4.54	11.20	16.65	18.73

Source: Lionbridge Capital and Lianhe Global's calculations

Challenged Credit Profile and Asset Quality amid Recent Undesirable Market Environment

SCFL witnessed a consistent increase in risky assets, accompanied by fluctuations in net asset scale from 2020 to the first nine months of 2023. Concurrently, the total assets of SCFL experienced a slight decrease at end-September 2023 after a continue increase from 2020 to 2022, which was mainly due to a reduction in leasing assets, driven by decreased demand for customer withdrawals in the leasing business following the decrease in bank loan interest rates.

By the close of 2018 and 2019, all financing lease receivables of SCFL were deemed normal. However, in 2020, pandemic-related payment delays led to assets being categorized as watchlist and subprime. Although some assets reverted to normal status, others remained overdue, prompting their classification as suspicious or loss assets by end-2022. The watchlist loans continue to increase as of end-September 2023, accounting for 12.6% of the total leasing receivables at the time. On the other hand, SCFL's default rate and overdue rate stood at 0.07% and 0.2%, respectively, in 2022. These rates increased slightly to 0.13% and 0.2%, respectively, in the first nine months of 2023, indicating a shift in the risk profile of SCFL's leasing business.

The risk management system of SCFL is comprehensive and encompasses various stages from project inception to post-leasing management. Having said that, further enhancements are needed to cope with its business expansion. Thus, SCFL is in the process of refining its risk management framework to establish a more robust system.

Financial Profile

Moderately volatile profitability

SCFL's gross profit margins were relatively stable at 34.5%, 40.0%, and 39.0%, respectively, from 2020 to 2022. However, there was a slight decline in gross profit in the first nine months of 2023, primarily due to the decrease in bank loan interest rates, which squeezed the profit margins in the leasing industry. Over the same period, the annualized return on equity showed a decreasing trend, with rates of 15.6%, 10.1%, 3.0%, and -0.2% in 2020, 2021, 2022 and the first nine months of 2023, respectively. Excluding the factor of shareholder injections, there has been an overall declining trend, mainly due to an increase in bad debt provisions by the original equity holders.

The advantageous position of SCFL, stemmed from its strong market foothold in Huangpu, is anticipated to contribute to a favourable and stable profitability trajectory in the future. Besides, as the major finance leasing company in the Science City, the company enjoys a distinct advantage in securing key projects.

Adequate Capital to Support Growth

SCFL received several times of cash capital injections between 2020 and the first-nine months of 2023, enlarging the company’s paid-in capital to RMB1.3 billion at end-September 2023 from RMB300 million at-end 2020. SCFL’s capital adequacy, as measured by common equity to total Assets (tangible), increased to 21.1% from 11.5% over the same period. This has strongly supported SCFL’s loss absorption capacity. We expect the company to utilize its strong capitalization for business expansion, as its leverage (risk assets to equity) was far below 8x (end-September 2023: 4.34x), though subjecting to the borrowers’ demand.

Good Access to Fundings

In addition to capital injections, SCFL has good access to various financing channels, mainly including bank borrowings and issuance of asset-backed securities (“ABS”). At end-September 2023, the company had total bank facilities amounting to RMB2.7 billion, of which RMB759 million was unused. It also has available ABS issuance quota of RMB777 million. Its majority shareholder, SCI Group has provided financial guarantees for most of its bank borrowings or promised to reimburse the any losses for ABS investors. Such guarantees or promises effectively lower SCFL’s financing costs and improve the stability of its fundings.

Moderately Tight Liquidity

However, SCFL’s liquidity was moderately tight. At end-September 2023, liquidity assets only covered 17.6% of SCFL’s debts due within one years. Moreover, the company highly relied on short-term fundings, as short-term debts contributed 68.3% of the company, while majority of outstanding leasing had a maturity of two to three years, creating a significant duration mismatch. As a result, SCFL need to frequently refinance its debts and thus subject to the market risks.

Exhibit 2: SCFL’s Key Financial Metrics

RMB million	2020	2021	2022	9M2023
Total Assets	3,058.4	5,753.3	7,548.8	6,942.6
Gross Finance Lease Receivables	2,803.5	5,019.2	6,442.9	6,027.1
Total Equity	351.7	1,082.4	1,115.8	1,466.2
Net Profit	46.0	72.2	33.4	-2.1
Return on Average Assets (%, annualised)	1.5	1.6	0.5	-0.04
Return on Average Equity (%, annualised)	15.6	1.6	0.5	-0.04
Impairment Charges to Average Gross Receivables (%)	0.4	1.3	2.6	0.02
Loan Loss Reserves to Gross Lease Receivables (%, annualised)	0.9	1.7	3.9	4.2

Impaired Loans to Gross Leasings	0.01	0.09	0.09	0.13
Risk Assets to Total Equity	8.3	4.9	6.0	4.3
Common Equity to Total Assets (tangible, %)	11.5	18.9	14.8	21.1
Short-term Debt to Total Debt (%)	64.1	61.4	56.6	68.3
Liquid Assets to Short-term Debt (%)	8.8	21.3	26.9	17.6

Source: SCFL and Lianhe Global's calculations

External Support

Strong External Support from SCI Group

SCFL would likely receive strong support from SCI Group to ensure its stable operation, considering SCI Group's majority ownership of SCFL, strong integration and linkage, the potential impact on SCI Group's reputation.

SCI Group's Ownership and Support

SCI Group directly and indirectly owns 86.88% shares of SCFL, and SCFL is the only financial lease company under SCI Group. As the majority shareholder, SCI Group has strong control over SCFL, including management appointments and decisions on major investment and funding plans.SCI Group has provided financial guarantees to most of SCFL's debt, significantly increasing SCFL's access to funds.

SCI Group's Ability to Provide Support

SCI Group is the largest comprehensive LIDC in terms of asset size in Huangpu District, a major administrative region under Guangzhou and a national level economic development zone. SCI Group is primarily responsible for project development, industrial investment and city operation within the region.

SCI Group received ongoing operational subsidies from the local government in relation to providing public services. The local government also injected assets and cash capital into SCI Group to enhance its equity base. Considering the high strategic importance of SCI Group in promoting economic and social development, and the relatively strong economy and fiscal conditions of Huangpu District, we believe SCI Group's ability to provide support is high.

Appendix I: SCFL's Rating Factors

Key Factors	Weight	Initial Rating
I. Operating Environment	15.00%	bbb
II. Business Analysis	25.0%	bb
III. Governance and Management	5.0%	bbb
IV. Risk Management and Exposures	20.0%	bb+
V. Financial Profile	35.0%	bb
Stand-Alone Creditworthiness	100.0%	bb+
VI. External Support		+2
Issuer Credit Rating		BBB

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.