Ongoing Viability of LIDCs Remains Essential in Underpinning China's Economy and Debtholders' Confidence

China's local investment and development companies ("LIDCs"), also generally known as local government financing vehicles ("LGFVs"), have been established to facilitate local infrastructure and land developments and the provision of public goods and services.

LIDCs' business activities and revenue profiles have been increasingly diversified following the economic development and urbanization of the regions in which they operate. More and more LIDCs have pursued market-oriented business activities with reduced involvement in public projects (e.g. infrastructure and affordable housing constructions) and less reliance on government subsidies. Having said that, LIDCs' business development still usually follows the guidance of their respective local governments and is closely linked to their regional development plans. To help LIDCs generate stable income, some local governments have injected operating assets or franchise rights of infrastructure and public services such as urban water supply, sewage treatment, and public transportation to their associated LIDCs.

As LIDCs continue to maintain close ties with their respective local government owners or controllers in carrying out government policies, we continue to expect that LIDCs will play a pivotal role in fostering regional economic growth, industrial transformation, employment, social security and tax revenue in China.

Potentially High Contagion Risk of Defaults on Publicly Traded Bonds of LIDCs

We believe that LIDCs' defaults on their publicly traded bonds would have significant contagion risk given their homogenous business profiles and similar credit risk features. LIDCs are generally government-funded entities carrying out various public policy missions as an extension of government functions, with repayments stemming primarily from receivables, subsidies or capital from their respective government owners. Therefore, the creditworthiness of an LIDC is usually linked to its sponsoring local government, although a shift towards market-oriented activities would reduce its reliance on government funding.

We consider that an LIDC's default could hamper the funding capability of other LIDCs under the same local government. This in turn would disrupt the continuing provisions of essential public services and other government functions, and may lead to social instability and an economic downturn in the region. In addition, given that publicly traded bonds of LIDCs are highly transparent and usually held by a diverse group of investors, the impact of an LIDC's default on its outstanding bonds could spread to neighboring regions and regions with similar economic and fiscal conditions. It could also undermine investor confidence and impede LIDCs' accessibility to the bond market.

Policy Support and Funding Flexibility Sustain Debt Repayment Capability

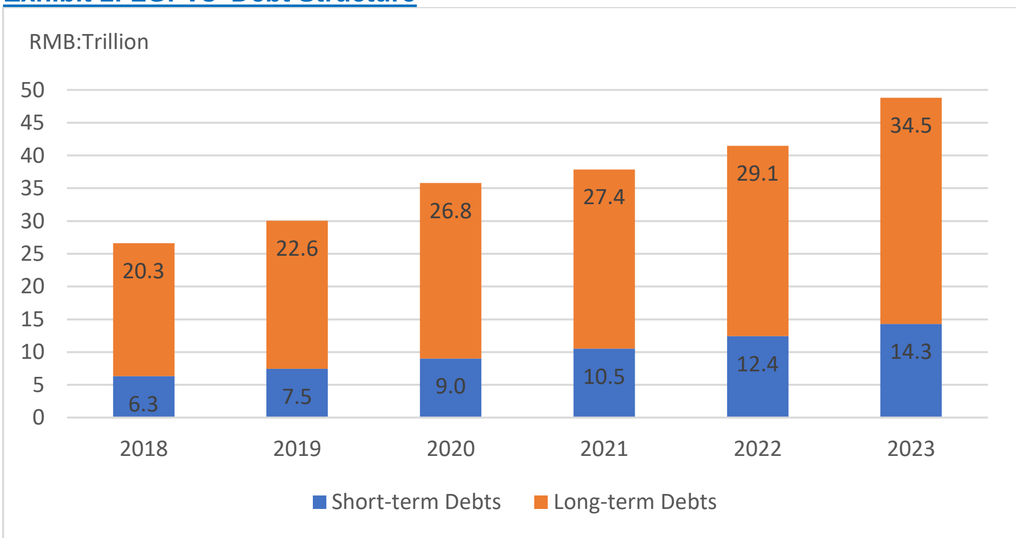
We expect that proactive policy measures and ongoing external funding capability will likely lead to lower funding costs and healthier debt structures of LIDCs. Against China's administrative system, provincial governments may assume greater responsibility for handling LIDCs' indebtedness within their jurisdictions, particularly if local governments within a province have weak capacity to support LIDCs. However, direct capital support would be unlikely to prevent moral hazard.

The impact of the pandemic, policies to reduce taxes and fees, and the decrease in government fund income during the property market downturn undermined the fiscal strength of local governments in certain areas. To resolve local debt risks, China's central government has proposed a series of measures, mainly including limiting the growth of LIDC debts and emergency lending provided by policy banks. The central government also plans to increase the issuance of ultra-long-term special-purpose treasury bonds, aiming to support key national projects, which could lower local governments' investment burdens and capital needs.

Provincial governments generally have more resources and stronger coordination capabilities than municipal, district and county governments. Some provincial governments have issued special-purpose refinancing bonds with lower borrowing costs and longer maturities to replace LIDCs' existing debts, effectively easing their debt repayment pressure. In addition, we believe that other financing instruments such as bank borrowings and non-traditional financing (obtained through trusts, asset management plans, financial leases, etc.) would continue to provide contingent financing flexibility. These loans are often bilateral in nature or involve only a small number of borrowers, indicating that negotiations with lenders are feasible if necessary. Moreover, local governments usually have significant influence over banks, especially those regional banks in which local governments have equity stake. We noted that some LIDCs with serious indebtedness restructured their bank loans or trust loans through extension, interest rate cuts or even principal reductions to resolve their debt risks.

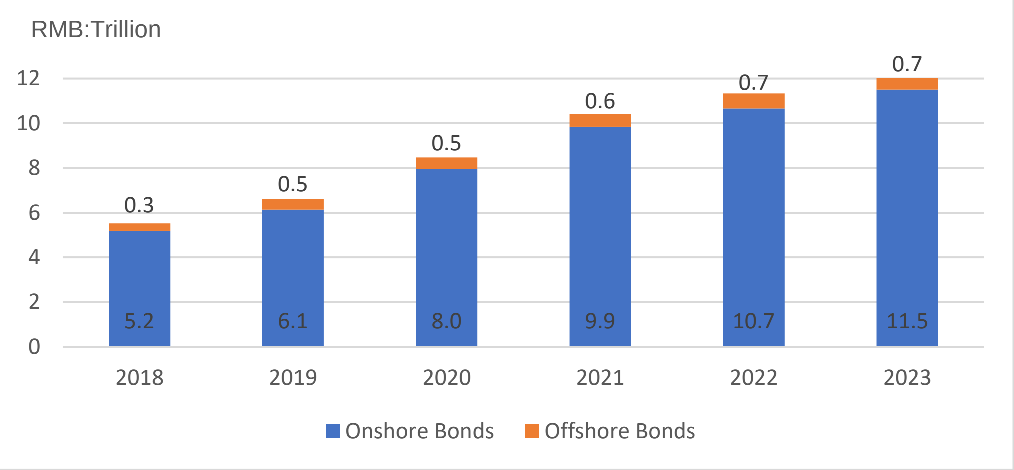
China's LIDCs mainly rely on bank loans, bond issuance and non-traditional financing, as well as government funds and equity capital to support their operations. Bank loans typically represent the largest share of interest-bearing debt, followed by bond issuance and non-traditional financing.

Exhibit 1: LGFVs' Debt Structure



Note: The year-end balance of LGFVs' outstanding debt categorized by Wind
Source: Wind and Lianhe Global's calculations

Exhibit 2: LGFVs' Onshore and Offshore Outstanding Bonds



Note: The year-end balance of LGFVs' outstanding bonds categorized by Wind
Source: Wind and Lianhe Global's calculations

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