Industrial Transformation of China’s LIDCs and Related Credit Rating Considerations

China’s local investment and development companies (“LIDCs”), also generally known as local government financing vehicles (“LGFVs”), are progressively advancing market-oriented operations against the backdrop of the central government’s enhanced oversight of local debt. Their industrial transformation directions are diversified, primarily focusing on industrial investment, resource integration, and expansion into market-oriented businesses, with varying degrees of marketization. Lianhe Ratings Global Limited (“Lianhe Global”) typically employs a “Two-Factor Assessment Mechanism” when evaluating their creditworthiness, considering both the entity’s standalone credit profile and the likelihood and extent of external support (usually from its local government shareholder). In addition, Lianhe Global believes that for strategically important entities, even with a high degree of market-oriented activities, the government may still provide support at critical junctures to maintain local economic and social stability. Therefore, the likelihood and extent of government support remain an important factor in credit assessments.

LIDCs’ Industrial Transformation Towards Market-Oriented Operations

Chinese LIDCs have historically played a crucial role in local infrastructure construction and urban development, facilitating rapid urbanization through financing and constructing urban infrastructure projects. However, as urbanization in various regions enters a stage of high-quality development, the demand for urban upgrades slows, and the scope for infrastructure investment narrows. The previous development model of LIDCs is no longer suited to the current market environment and regulatory requirements. Concurrently, with the central government strengthening control over local debt risks, LIDCs are gradually undergoing industrial transformation and promoting market-oriented operations, aiming to achieve self-sufficient in funding and decouple from local government credit.

LIDCs’ transformation is evolving from their traditional roles as infrastructure developers and financing vehicles into entities such as industrial investment bodies, comprehensive urban service providers, or state-owned capital operation companies. Unlike traditional LIDCs, these entities no longer focus on infrastructure financing as their core function. Instead, their main directions encompass industrial investment, resource integration, and expansion into market-oriented businesses, covering various forms such as state-owned capital investment and holding, industrial consolidation, diversified operations, and urban operations. These enterprises are moving towards more market-oriented management and operations, with diversified businesses including public utilities, energy and transportation, industrial parks, cultural tourism and wellness, ecological and environmental protection, supply chain management, equity investments, and operational asset management. As their business development primarily utilizes resources within their operating regions, they typically exhibit distinct regional characteristics. They engage in operational businesses to pursue market-based revenue and cash flow generation, focusing on preserving and increasing the value of state-owned assets and promoting regional industrial development.

The degree of marketization among these transforming entities may vary. Public utility operators mainly undertake public service functions such as water supply, heating, and waste treatment, often operating under franchise models with regional exclusivity. Their pricing is generally subject to government guidance, reflecting strong policy attributes and a lower degree of market orientation. Entities extending their original infrastructure functions into areas like tourism development, park property management, and hotel operations, while still related to urban construction, are gradually developing certain commercial operating capabilities. Furthermore, entities expanding into various industrial sectors based on local resource endowments generally lean towards market-oriented operations and bear their own profits and losses. For these independently operated enterprises, credit assessments tend to place greater emphasis on the entity’s own financial soundness and its competitiveness within the industry.

Lianhe Global Employs a “Two-Factor Assessment Mechanism”

Lianhe Global typically assesses the creditworthiness of local state-owned enterprises directly or indirectly owned by Chinese local governments or their departments based on the published “China Local Investment and Development Companies Criteria”; other rating methodologies may be referenced as needed. When evaluating the credit profile of these local state-owned enterprises, we employ a “Two-Factor Assessment Mechanism”, which considers both the entity’s standalone credit profile and the likelihood and extent of support from the local government.

Standalone Credit Profile of the Entity

This includes business profile and risk, management quality, asset quality, capital structure, profitability, liquidity, and debt servicing capability.

Likelihood and Extent of Local Government Support

This assesses whether the entity is likely to receive support from the local government if needed to sustain its ongoing operations. The assessment of the government’s willingness to support primarily considers the following four factors:

Strategic Importance: Whether the entity plays a critical role in the local economy and social development.

Potential Impact of Default: Whether a default by the entity could trigger contagion or systemic risks.

Ownership and Control: Whether the local government is a major shareholder and supervises the entity’s operations.

Operational and Financial Support: Whether there is the existence of fiscal subsidies, policy preferences, capital injections, etc.

Strategically Important Entities May Still Receive Government Support if Needed

As the transformation of Chinese LIDCs deepens, their market-oriented operational attributes strengthen. They are gradually evolving from local government financing and investment vehicles into comprehensive urban service providers, industrial investment bodies, or capital operation companies with independent operational capabilities. In this process, the government subsidies and resource support they rely on may gradually diminish, and credit assessments increasingly focus on the entity's own operational capabilities, financial robustness, and cash flow generation capacity.

However, Lianhe Global believes this transformation does not completely sever the ties between the government and the entities. The likelihood and extent of local government support remain an important consideration in credit assessments of local state-owned enterprises. In particular, for local state-owned enterprises with strategic importance to the local economy, social security, and industrial development, Lianhe Global believes local governments still possess the willingness to provide support when necessary to ensure the entity's continued operation, avoiding damage to local economic and social stability or the spread of credit risk. Such support may be manifested not only in explicit measures like financial aid, asset injections, or debt restructuring but also in policy coordination, resource allocation, and franchise grants.

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