

Factors to Consider When Analysing the Credit Profiles of Chinese LGFVs

Lianhe Global examines a basket of elements when analysing the credit profiles of China's Local Government Financing Vehicles ("LGFVs"). In this commentary, we highlight some of the key factors which are important for a thorough credit analysis of Chinese LGFVs.

1. Business models and contractual agreements

In most cases, whether an LGFV has a clear business model with sufficient funding to support its public welfare function is primarily based on the existence of and content of the contractual agreements signed between the relevant government departments and the LGFV. Projects without signed agreements usually have high uncertainty in future revenue recognition and payment. Large-scale construction in progress or inventory is likely to occur, which may require significant external financing and adversely affect the liquidity of the LGFV.

2. Government-related and market-oriented business development

The policy function of an LGFV has a great impact on the possibility of receiving government support. We observe the evolution of an LGFV's main business to see if there is any transfer of the LGFV's policy role to the other LGFVs. For example, the other LGFVs take on similar government functions while the LGFV's policy-related business has been shrinking or suspended.

With regard to the market-oriented business development, Chinese LGFVs currently have been focusing on the financial and trade sectors in most cases. We pay attention to the asset quality of the financial business and the concentration of upstream suppliers and downstream customers of the trade business as well as potential capital needs for its business growth.

3. Status of receivables

LGFVs usually have notable government-related receivables. Large receivables especially with long durations from government-related entities may imply a weak liquidity profile of the associated governments. Some governments may reach repayment arrangements with LGFVs where we would look into the actual cash collections. We also pay attention to the credit exposure to the other LGFVs and ask for their uses of proceeds and the repayment arrangements especially if the funds are on-lent to the other borrowers.

4. Debt composition and maturity

We look at the composition of an LGFV's debt funding and are cautious if the proportion of non-standard borrowings (for example trust products) is high or if there are any equity-like instruments, such as perpetual bonds, as these kinds of vehicles usually have higher borrowing costs than bank loans and straight bonds.

We review LGFV's debt maturity profile to evaluate its liquidity and financing pressure. We pay attention to LGFV bonds with put options as bondholders can force the LGFV issuer to repurchase their bonds through the put provision, accelerating the debt repayments.

5. Contingent liabilities

Some LGFVs may have significant third-party guarantees which require further review, such as reviewing the underwriting guidelines and the credit approval process as well as the potential influence from the associated local governments. It is also important to look into the credit profile of the LGFV's existing exposures. Exposures to private-owned enterprises usually cause more concern than those to state-owned entities.

We note that some LGFVs have pending legacy law suits, which may reflect their weak internal risk management and control, although the eventual loss may not be significant.

6. Potential government support

The forms of government support an LGFV has received help us access the likelihood and strength of government support for the LGFV to sustain its viability. LGFVs may receive government funds to replace their debts where we prefer the replacements in the form of capital injection, compared with borrowing from the governments. In addition, we look into an LGFV's asset composition and evolution, particularly any asset acquisitions, divestitures and restructurings under the instructions of local governments.

In short, these are some of the noteworthy key elements Lianhe Global considers when analysing the credit profiles of Chinese LGFVs. While there are many other key factors, we would like to bring attention to the investing community of the aforementioned factors which have not garnered much attention but are important for a thorough credit analysis.

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