Perceived Weaker Support Strains China's Local Government Financing Vehicles

China's Local Government Financing Vehicles ("LGFVs") have incurred higher funding cost amid tightened regulations on their debt financing and perceived lower possibility of support from their respective local governments ("LGs") in case of need. Investors' risk aversion has pushed up their borrowing costs, particularly for issuers with weaker credit profile, i.e. with onshore ratings of 'AA' and below.

LGFVs are facing increasing refinancing risk as they have been relying on debt borrowing to support their operations, resulting in rising indebtedness and deteriorating debt servicing capability. As support from LGs would be more likely for those highly rated LGFVs performing an important role in supporting the regional economy, pressure on issuers with lower ratings would be more pronounced. In addition, LGFVs with lower ratings generally have relatively weaker operating and financial performance or located in areas with weaker economic conditions or fiscal positions.

Regulatory Tightening on LGFV Financing

China's regulatory authorities have put risk prevention as their primary goal in 2018 and have issued several policies aiming to crack down disorderly debt financing through LGFVs while granting a "front door" channel that allows LGs to raise money transparently. Newly issued major policies in 1H18 include No.34, No.194, and No.23, which provide more specific and detailed guidance and are extensions of No.43 issued in 2014.

The newly promulgated policies require strengthening the management, supervision and audit of LG debt. The authorities continue to strictly prohibit LGs from extending their implicit liabilities arising from the bond issuances by their underlying LGFVs and decouple the perceived support of LGs to LGFVs' debt obligations. Meanwhile, the authorities tighten the financing channels via public-private partnerships projects and non-standard financial instruments.

On the other hand, China introduced LG special bonds in 2015 as an alternative and more transparent funding channel to support LGs' projects. The authorities increased the quota of LG special bonds from CNY800 billion to CNY1,355 billion in 2018 which included the shanty town renovation projects in addition to the other three types of government projects: land reserve, toll roads, and rail transit. Special bonds shall only be covered by returns from the project being funded. The central government also plans to reduce LGs' fiscal pressure by transferring part of the public service expenditure from LGs to the central government.

Investors Favour Short- and Medium-term High Grade LGFV Bonds

Investors have switched their preference to short- and medium-term LGFV bonds with onshore ratings of 'AA+' and 'AAA', considering the heightened policy risk on LGFV financing and perceived lower possibility of support from their respective LGs. LGFVs incurred higher funding costs as a result of investors' risk aversion. The median coupon rate for bonds issued in 1H18 by issuers with 'AA-' onshore rating increased by 1.02 percentage

points to 7.4% (compared with the median coupon rate of bonds issued in 1H17), much higher than the 5.13% for issuers with 'AAA' rating. The same median coupon rate for 'AAA' rated LGFVs only increased 0.39% during the same period.

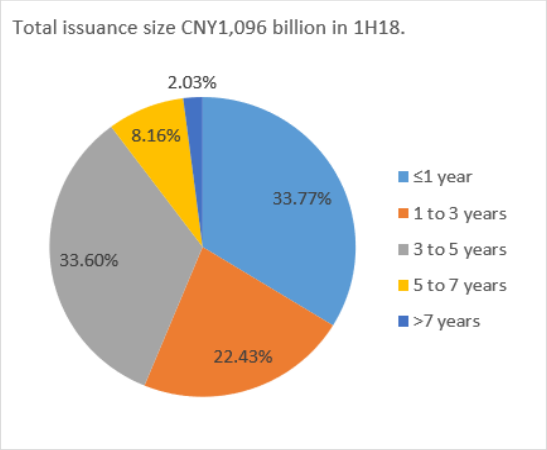
The total issuance size increased notably by 62% year-on-year to CNY1,096 billion in 1H18, with more than 50% being short- and medium-term bonds (maturities shorter than 3 years). The bonds issued by issuers with 'AAA' and 'AA+' onshore ratings accounted for 43% and 33%, respectively, of the total new issuances in 1H18 and Jiangsu province had the largest issuance amount of CNY232 billion, accounting for 21.2% of the total issuance. The outstanding balance of Jiangsu province was the biggest totalled CNY1,591 billion at end-1H18 (17.9% of the total outstanding balance), significantly higher than the second largest CNY643 billion of Hunan province.

EXHIBIT 1: Comparison of Coupon Rate for Bonds Issued in 1H18 and 1H17

Onshore Credit Rating	1H18		1H17	
	Range of Coupon Rate	Median	Range of Coupon Rate	Median
AAA	3.65~7.50	5.13	3.69~6.37	4.74
AA+	4.50~7.95	5.99	3.88~7.00	5.24
AA	5.00~8.50	6.88	4.12~7.50	5.80
AA-	5.70~8.10	7.40	4.99~7.80	6.38

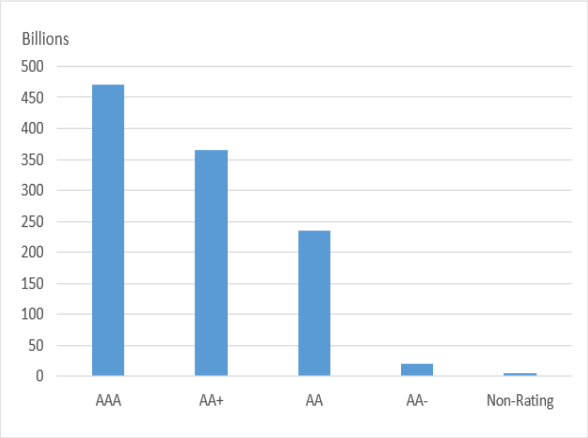
Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

EXHIBIT 2: Breakdown of Bonds Issued in 1H18 by Maturity



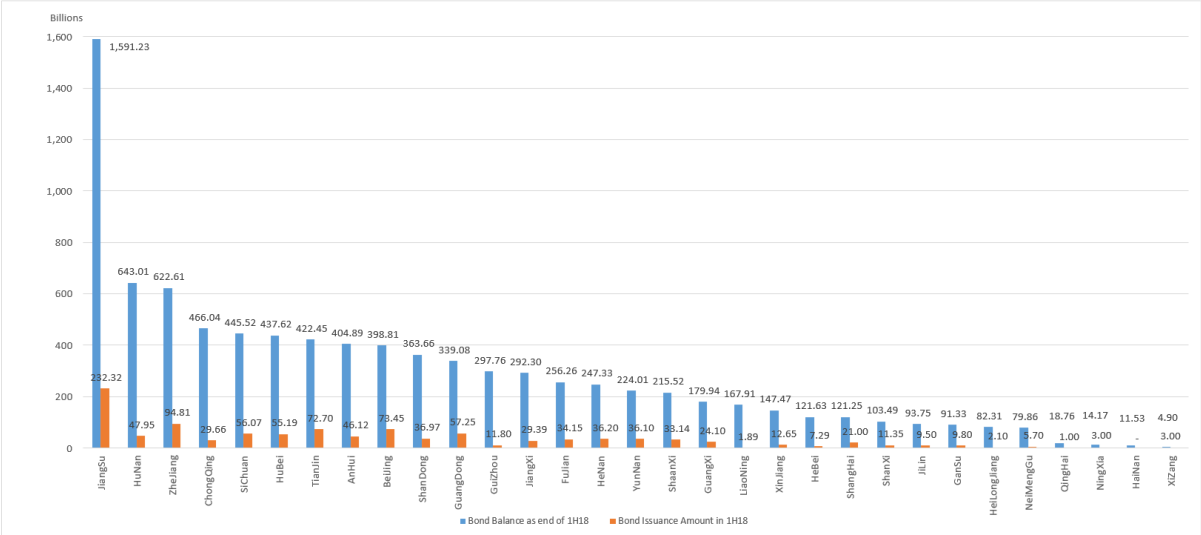
Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

EXHIBIT 3: Breakdown of Bonds Issued in 1H18 by Issuer Rating



Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

Exhibit 4: Bond Issuance Amount in 1H18 and Outstanding Balance at End-1H18 by Province

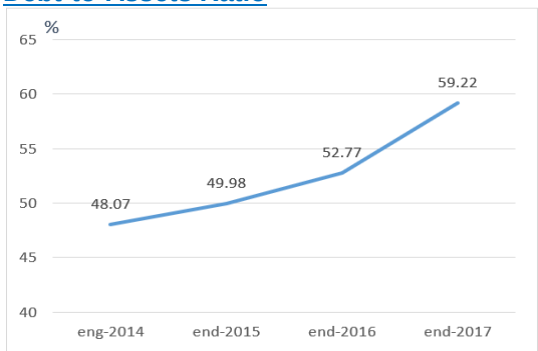


Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

Weakened Debt Servicing Capability on Rising Indebtedness

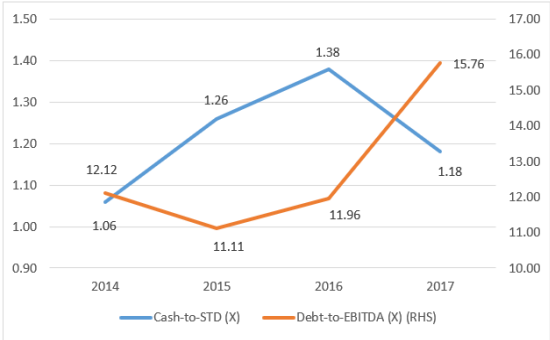
LGFVs have generally incurred cash outflows from their operating and investment activities, and continue to rely on debt financing to support their business. Total outstanding debt balance increased 17% in 2017 to CNY33.2 trillion and the aggregate debt-to-asset ratio rose to 59% at end-2017, from 48% as of end-2014. The overall debt servicing capability deteriorated with the aggregate cash to short-term debt ratio dropping to 1.18x (1.38x at end-2016) and total debt to EBITDA ratio increasing notably to 15.76x at end-2017 (11.96x at end-2016). Refinancing pressure is high as the overall balance of LGFV's outstanding bonds was CNY8.9 trillion at end-1H18, among which 50% of the debts will be due by 2021.

EXHIBIT 5: The LGFV Sector's Aggregate Debt-to-Assets Ratio



Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

EXHIBIT 6: The LGFV Sector's Debt Servicing Performance



Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd.

Strengthened Support or Improved Standalone Performance Drove Rating Upgrades

Onshore rating agencies upgraded 60 and downgraded 6 LGFVs in 1H18. Demonstrated stronger support from LGs or improved standalone credit strength are key drivers for the rating upgrades.

The upgraded issuers are mainly domiciled in regions with more advanced economic development and steady growth in fiscal revenues, as these areas provide better prospects for LGFVs' development and fund raising. External supports from LGs, including share transfers, capital injections, and financial subsidies, were mainly earmarked for LGFVs which have played important roles contributing to the regional economic growth (such as infrastructure development platforms). LGFVs showing improved credit profiles include utilities entities with stable operations and companies with good revenue growth prospects from large-scale land and infrastructure developments.

Source: Wind; *LGFV report in 1H18*, United Credit Ratings Co., Ltd, published on 9 August 2018.
Note: In case of any discrepancies between the English version and the Chinese version, the Chinese version shall prevail.

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