China LGFV 2020 Outlook: Fiscal Stimulus to Support China's Economy Will Underpin LGFVs' Credit Profile

Summary and Outlook for 2020

LGFVs' Policy Functions Remain Intact

China has reembraced the investment-driven growth model since 2H2018 to boost its economy, which reported a slowing year-on-year GDP growth of 6% in 3Q2019. We believe that local governments' direct funding capacity will remain insufficient to support their capital spending needs, especially with the acceleration of infrastructure investment to counter the economic slowdown. Local government financing vehicles ("LGFVs") will continue their important role particularly in infrastructure construction to support China's economic development.

Government Support Favours Large LGFVs with Strong Policy Functions

The Chinese government has introduced several measures since 2H2018 to alleviate LGFVs' financing pressure. However, we do not foresee a reversal of the regulatory authority's ambition to de-risk the financial system and expect LGFVs' credit profiles to diverge on the various levels of government support mainly though asset/capital injections.

Large LGFVs carrying important policy roles (such as improving local residents' livelihoods and boost the economic development) have been in a better position in business expansions and financing underpinned by stronger government support. They will likely continue to take on major infrastructure projects, which will further strengthen their policy roles and government linkages and will foster their respective local government authorities to provide constant support. On the other hand, liquidity pressure will continue to challenge those LGFVs with insignificant government functions or located in areas with weaker economic conditions or fiscal positions.

Consolidation and Centralisation of Funding Activities to Strengthen Management Control

We expect more consolidations among China's LGFVs, particularly in relatively lower administrative levels (i.e. the prefectural level and below), due to increased difficulties for small LGFVs with weak credit profiles to seek financing and the Chinese authority's ambition to enhance the supervision of LGFVs. The consolidation to integrate several small LGFVs into a single large one taking on the sole responsibility of financing and investing functions in one region should help reduce their funding cost, increase operating efficiency, as well as exercise more effective debt monitoring and controls of irregular business activities. In addition, we expect the trend of LGFVs' involvement in commercial activities such as the trade and financial businesses will continue, which would increase the complexity of their business profile and weigh on their capitalisation in the absence of adequate profitability.

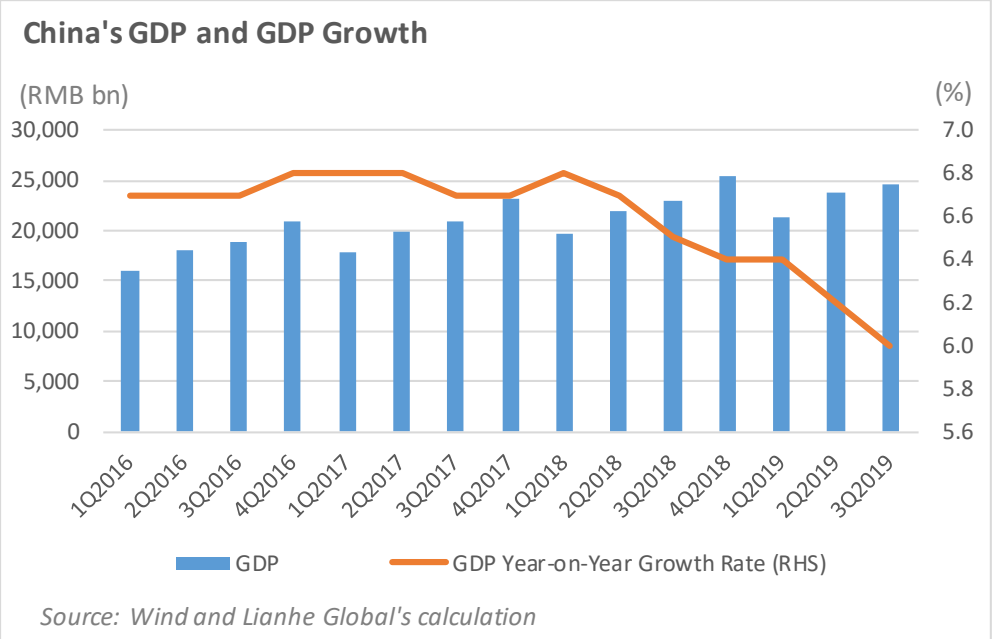
Local Economies and Governments

Slowing Economic Growth amid Lingering Trade Tension

China's GDP growth decelerated to 6.0% year-on-year in 3Q2019, from 6.2% in 2Q2019 and 6.6% in 2018, when it is undergoing a structural transformation from an export- and investment-driven economy to the one led by consumption and facing the trade friction between China and the United States. The slowing economy has driven the shift of policymakers' priorities to ease monetary and fiscal policies. We foresee that the government will purse greater public sector spending, particularly infrastructure investment, to underpin China's 2020 economic growth.

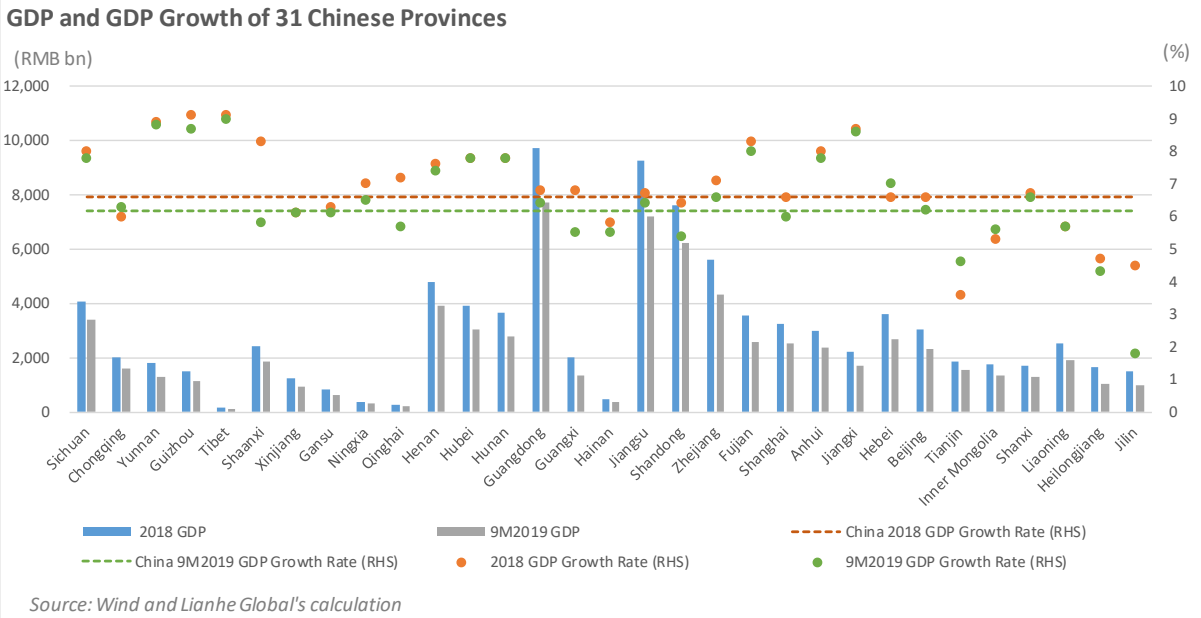
Some provinces in the coastal areas still maintained strong economic growth, such as Fujian and Anhui, with year-on-year GDP growth rates of 8.0% and 7.8% in 9M2019, respectively. Guangdong, Jiangsu and Shandong were the three largest provinces, accounting for about 30% of China's total GDP in both 2018 and 9M2019, and their GDP growth remained at about the same level of the overall Chinese economy. The northeast region (including Jilin, Heilongjiang and Liaoning), which used to be China's heavy industry base, is experiencing difficulties in the process of economic transformation. These three provinces' GDP growth was weaker than the nationwide economic growth in 2018 and 9M2019. The growth rate of Heilongjiang and Jilin further slowed down in 9M2019 at 4.3% and 1.8%, respectively (2018: 4.7% and 4.5%), whereas Liaoning barely remained stable at 5.7% (2018: 5.7%).

EXHIBIT 1: China's GDP and GDP Growth



Source: Wind and Lianhe Global's calculation

EXHIBIT 2: GDP and GDP Growth of 31 Chinese Provinces



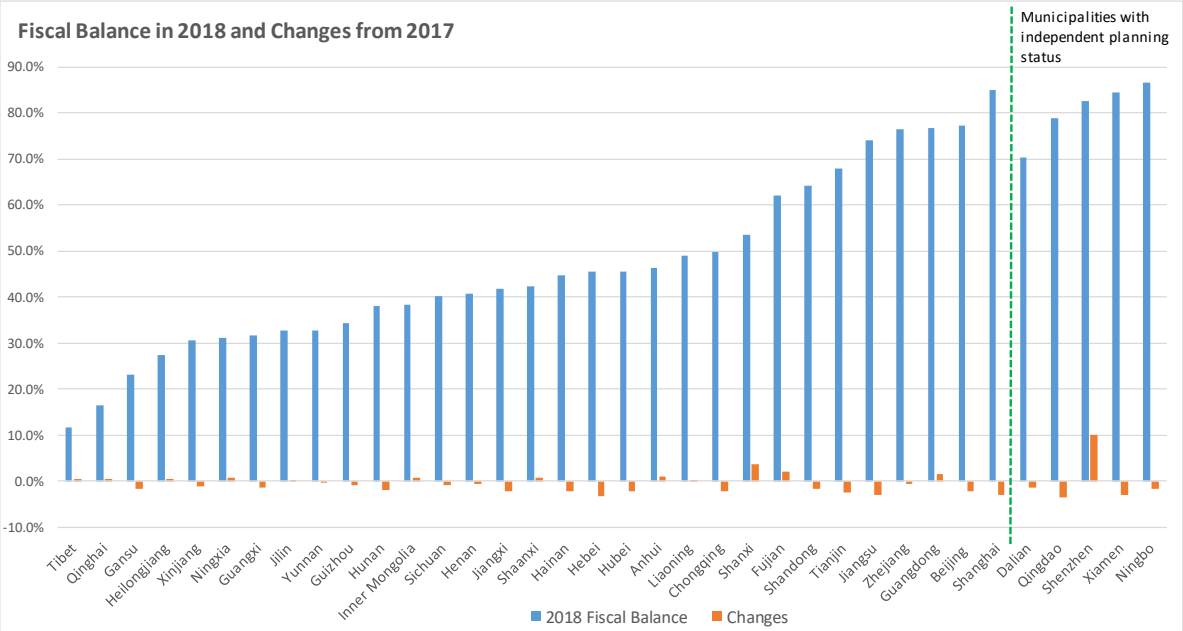
Source: Wind and Lianhe Global's calculation

Rising Fiscal Pressure on Increasing Expenditure

The Chinese governments, particularly at the regional and local level, would continue to increase debt financing in 4Q2019 and 2020 due to greater fiscal pressure amid a slowing economy. A more proactive fiscal policy will accelerate the increase in fiscal expenditure, while the economic slowdown will pressure the growth in tax revenue and regulatory controls on the real estate sector will weigh on the revenue from land sales. In addition, China's local governments are taking more financing activities which were previously mainly conducted by LGFVs, aiming at improving transparency and supervision on their direct and contingent liabilities.

Chinese local governments generally face fiscal deficits with the ratios of budgetary revenue to budgetary expenditure ("the fiscal balance ratio") falling in the range of 12% to 85% in 2018 for the 31 provinces. More than half of these local governments' fiscal deficits widened in 2018, although some governments have significant government fund income (mainly the revenue from land sales) or transfer payment to supplement their revenue. Less than one third of these local governments had a fiscal balance ratio of above 50% with Shanghai, Beijing and Guangdong ranking the top three (more than 75%), while Tibet, Qinghai and Gansu having the lowest of below 25% in 2018. The five municipalities with independent planning status, namely Dalian, Qingdao, Shenzhen, Xiamen and Ningbo, also maintained better fiscal condition with their fiscal balance ratios at above 70% in 2018.

EXHIBIT 3: Fiscal Balance in 2018 and Changes from 2017



*Note: 1. Fiscal balance = budgetary revenue / budgetary expenditure*100%; 2. Changes = fiscal balance in 2018 - fiscal balance in 2017*
Source: Wind, local government finance bureau and Lianhe Global's calculation

Policies & Regulations

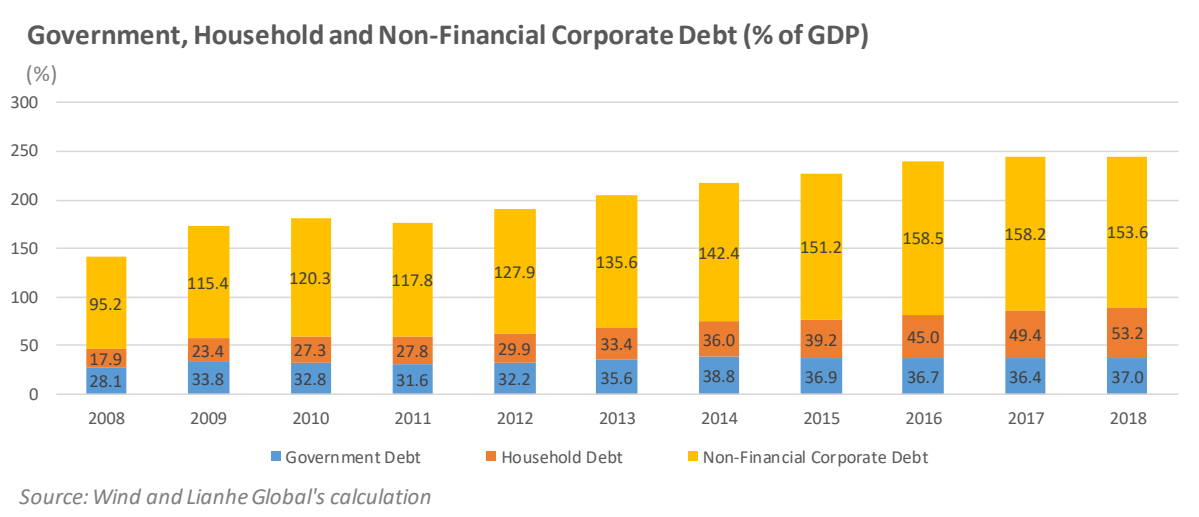
Policy Easing to Alleviate LGFV's Financing Pressure

The Chinese government has introduced several measures since 2H2018 to ease financial and monetary conditions amid a slowing economy, sluggish stock markets and renminbi depreciation pressure. The eased policy stance has alleviated LGFV's financing pressure. However, we do not consider this indicates a reversal of the authority's ambition to de-risk the financial system as China continues to grapple with the fallout from the rapid credit expansion following those huge stimulus measures taken a decade ago. The rapid debt accumulation has driven up the country-wide leverage to 243.7% at end-2018 from 141.1% at end-2008 as measured by the ratio of total non-financial sector debt to nominal GDP.

China's central bank has reduced banks' reserve requirements four times in 2018 and three times in 9M2019, and introduced other forms of liquidity injections to encourage lending. The China Banking and Insurance Regulatory Commission in May 2018 cancelled the ceiling on the purchase of local government bonds by underwriting banks to whet banks' appetite for underwriting and buying up local government debt. The requirement that commercial banks purchase no more than 20% of the bond issues for which they have served as lead underwriters was launched in 2012.

To support a proactive fiscal policy, the limit of China's special bond issuance amount increased to RMB2,150 billion in 2019 from RMB1,350 billion of 2018. In 3Q2019, the State Council expanded the usage of the special bonds and proposed local governments to finish issuing special debt within the 2019 quota by end-September 2019 and allocate proceeds to projects by end-October 2019.

EXHIBIT 4: Government, Household and Non-Financial Corporate Debt (% of GDP)

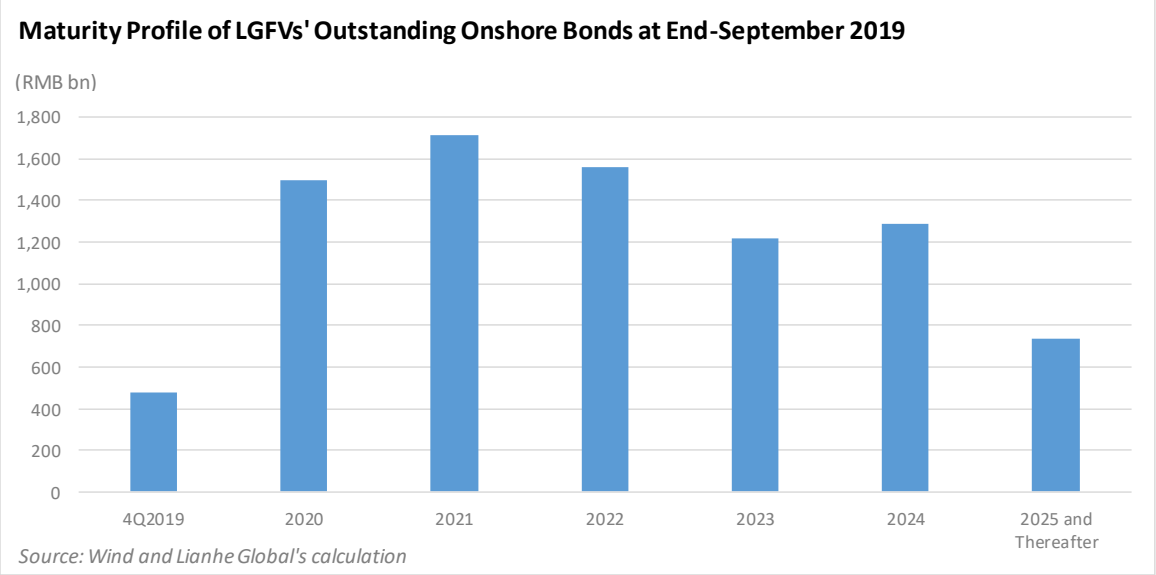


2019 Credit Review

Financing Activities Resumed Although Challenges Remained for Weak LGFVs

The onshore issuance amount notably increased following the regulatory relaxations in LGFVs' financing, although LGFVs with weaker credit profile incurred higher funding cost as a result of investors' risk aversion in 2019. Total outstanding onshore bonds of China's LGFVs were RMB8,500 billion at end-September 2019, compared with about RMB7,680 at end-2018. About 43.5% of these outstanding bonds will be due by 2021. Bonds issued by issuers with 'AA' onshore rating increased sharply by 163.8% year-on-year to RMB254.6 billion in 3Q2019 from RMB96.51 billion in 3Q2018. At the same time, the amount issued by issuers with 'AAA' rating increased by 73.97% year-on-year to RMB312.1 billion from RMB179.4 billion, and the amount issued by issuers with 'AA+' rating increased by 77.88% year-on-year to RMB285.9 billion from RMB160.7 billion.

EXHIBIT 5: Maturity Profile of LGFVs' Outstanding Onshore Bonds at End-September 2019



Benefiting from favourable policies for infrastructure financing, the coupon rates of the onshore bonds issued by LGFVs in 2019 were generally lower than the rates in 2018. The interest spread (the difference of the coupon rates of LGFV bonds and treasury bonds) narrowed in 2019 for most LGFV issuers with different credit ratings and bond durations, except the short-term bonds of AA-rated issuers. The weighted average interest spread of mid- and long-term bonds was 366.95 basis point for issuers with AA rating in 25 provinces, slightly lower than that of 2Q2019. Heilongjiang, Liaoning, Tianjin, Guizhou, Xinjiang and Jilin had higher spreads of more than 100 basis point above the aforementioned national average of 366.95. The coupon rates of short-term bonds issued by AA-rated LGFVs increased to 5.22% in 3Q2019 from 4.96% in 2Q2019 with widened interest spread of 270.44 basis point (2Q2019: 242.55 basis point), resulting from higher percentage of private placement among all onshore issuances.

China's LGFVs have reported increasing credit events with defaults on their non-standard financing instruments since 2018 and for the first time, an LGFV opted to pay a higher interest rate on its perpetual bonds instead of repaying the debt by exercising the call option in September 2019. Defaulted issuers were mainly in the regions with relatively underdeveloped economy and weak fiscal condition such as Yunnan, Guizhou and Tianjin. These credit events have negatively impacted the financing activities in this area, while we expect that the Northeast region, where is facing economic transformation difficulties, will continue to face above-average financing costs.

Appendix: List of Lianhe Global Rated LGFV Entities

Issuer	Province/City	Issuer Rating/Outlook
Liangshan Development (Holdings) Group Co., Ltd	Liangshan	BBB-/Stable
Qingdao City Construction Investment (Group) Limited	Qingdao	A-/Stable
Yancheng Oriental Investment & Development Group Co., Ltd.	Yancheng	BB+/Stable
Zhengzhou Urban Construction Investment Group Co., Ltd.	Zhengzhou	A-/Stable

Source: Lianhe Global

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