Chinese Government's Eased Attitude Towards LGFVs' Financing Activities Underpins Their Credit Profiles

Major Policy Announcements:

Financing policies for China's local government financing vehicles ("LGFVs") have been eased since 2H2018 due to the dynamic condition of China's macroeconomy and the financial system. China's regulatory authorities put risk prevention as their primary goal in 1H2018 and issued several policies aiming to crack down disorderly debt financing. They signalled relaxations in 2H2018, although financing activities remained constrained in the whole year of 2018 given the lagging effect of policy changes and some risks in this sector were exposed.

In 1H2018, the National Development and Reform Commission and the Ministry of Finance released policies No.194, No.34, and No.23. These policies required strengthening the management, supervision and audit of local government debt, strictly prohibiting local governments from extending their implicit liabilities arising from the bond issuances by their underlying LGFVs and decoupling the perceived support of local governments to LGFVs' debt obligations. These measures notably tightened LGFVs' financing channels.

In 2H2018, China's macroeconomic indicators showed a slowing economic growth momentum. The trade tension between China and the United States brought external pressure on export and employment, while deleveraging and economic structural transformation constrained domestic economic activities. Regulatory policies have been adjusted under these circumstances. On 23 July 2018, the National People's Congress and the executive meeting of the State Council released instructions that require financial institutions to ensure funding availability for LGFVs' reasonable financing needs. On 31 July 2018, the meeting of the Political Bureau of the CPC Central Committee released instructions pertaining to increasing infrastructure investments. And on 31 October 2018, the State Council issued No.101 policy guided financial institutions to support the financing needs for infrastructure projects.

LGFVs have experienced a tough financing period in the past year, although there were favoured policies released, but these still need some time for the effect to materialise. The LGFV bond market has gone through a confidence shock due to the default event of Xinjiang Production Construction 6th Shi State-owned Assets Management and several cases of deferred payments of non-standard financing instruments issued by LGFVs.

Investors Favour High Grade LGFV Bonds

Investors maintained their preference for LGFV bonds with onshore ratings of 'AA+' and 'AAA' in Jan-Nov 2018, while LGFVs incurred higher funding costs as a result of investors' risk aversion. The median coupon rate for bonds issued in Jan-Nov 2018 by issuers with 'AA-' onshore rating increased by 1 percentage points to 7.5% (compared with the median coupon rate of bonds issued in Jan-Nov 2017), much higher than the 4.76% for issuers with 'AAA' rating. The median coupon rate for 'AAA' rated LGFVs increased by only 0.1% during the same period.

The bonds issued by issuers with 'AAA' and 'AA+' onshore ratings accounted for 44.9% and 33.2%, respectively, of the total new issuances in Jan-Nov 2018. The amount issued by issuers with 'AAA' rating increased by 89.5% year-on-year to RMB965 billion from RMB509 billion. Whereas, bonds issued by issuers with 'AA' rating notably decreased by 37.7% year-on-year to RMB436.7 billion from RMB701.2 billion.

EXHIBIT 1: Comparison of Coupon Rates for Bonds Issued in Jan-Nov 2018 and Jan-Nov 2017

Onshore Credit Rating	Jan-Nov 2018		Jan-Nov 2017	
	Range of Coupon Rate	Median	Range of Coupon Rate	Median
AAA	2.64~7.50	4.76	3.69~6.50	4.75
AA+	3.70~8.20	5.78	3.88~7.50	5.42
AA	4.23~8.80	6.95	4.12~8.48	6.10
AA-	4.70~8.20	7.50	4.99~7.80	6.50

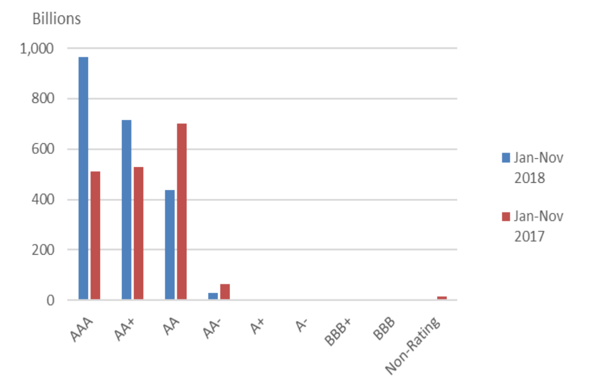
Source: Wind; *LGFV 2019 Outlook*, United Credit Ratings Co., Ltd.

Issuers Focus on Short- and Medium-term Bonds

The total issuance size increased by 18.25% year-on-year to RMB2,151.6 billion in Jan-Nov 2018, with 59.8% being short- and medium-term bonds (maturities less than 3 years) due to investors' preference. Bonds with maturities less than a year and between 1-3 years accounted for 33.8% and 26% of the total issuances, respectively. The high liquidity and short duration made these bonds more attractive for investors.

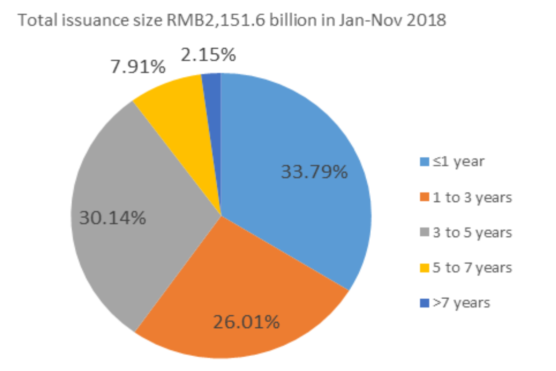
More than half (mainly economically better developed with higher fiscal revenue) of the 30 provinces/cities reported higher issuance amounts in Jan-Nov 2018 (compared with Jan-Nov 2017). Jiangsu province had the largest issuance amount of RMB447.5 billion or 20.8% of the total issuance in Jan-Nov 2018, significantly higher than the second largest issuance amount of Zhejiang which accounted for 8.4% of the total.

EXHIBIT 2: Breakdown of Bonds Issued in Jan-Nov 2018 and Jan-Nov 2017 by Issuer Rating



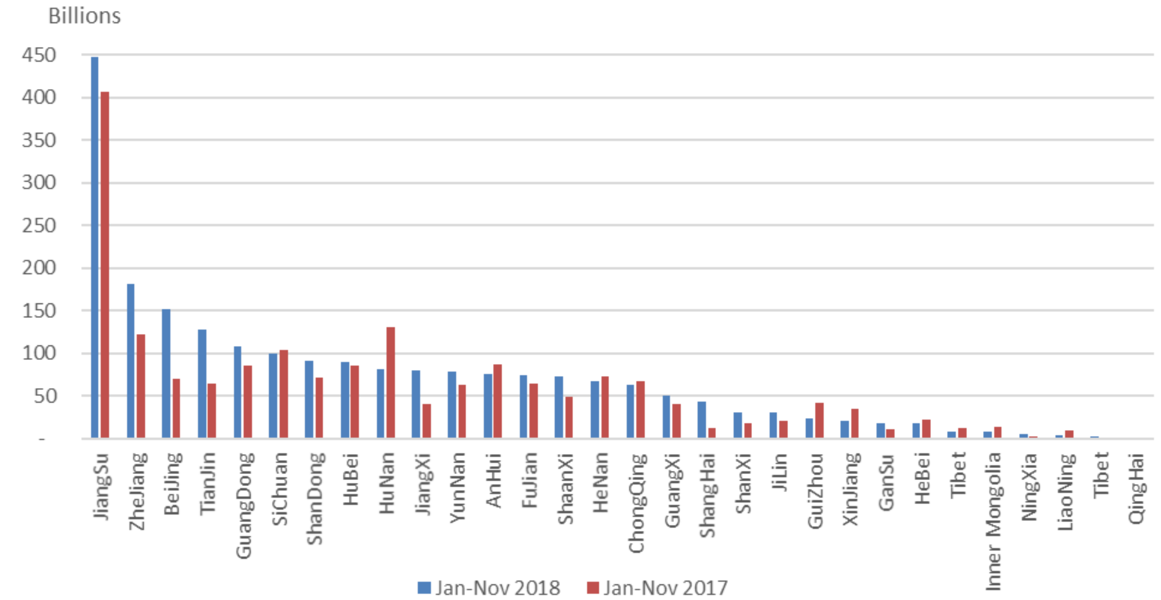
Source: Wind; *LGFV 2019 Outlook*, United Credit Ratings Co., Ltd.

EXHIBIT 3: Breakdown of Bonds Issued in Jan-Nov 2018 by Maturity



Source: Wind; *LGFV 2019 Outlook*, United Credit Ratings Co., Ltd.

Exhibit 4: Bond Issuance Amount in Jan-Nov 2018 and Jan-Nov 2017 by Province



Source: Wind; *LGFV 2019 Outlook*, United Credit Ratings Co., Ltd.

Weakened Local Government Fiscal Capacity and Deteriorated Standalone Profiles Triggered Rating Downgrades or Negative Outlook Revisions

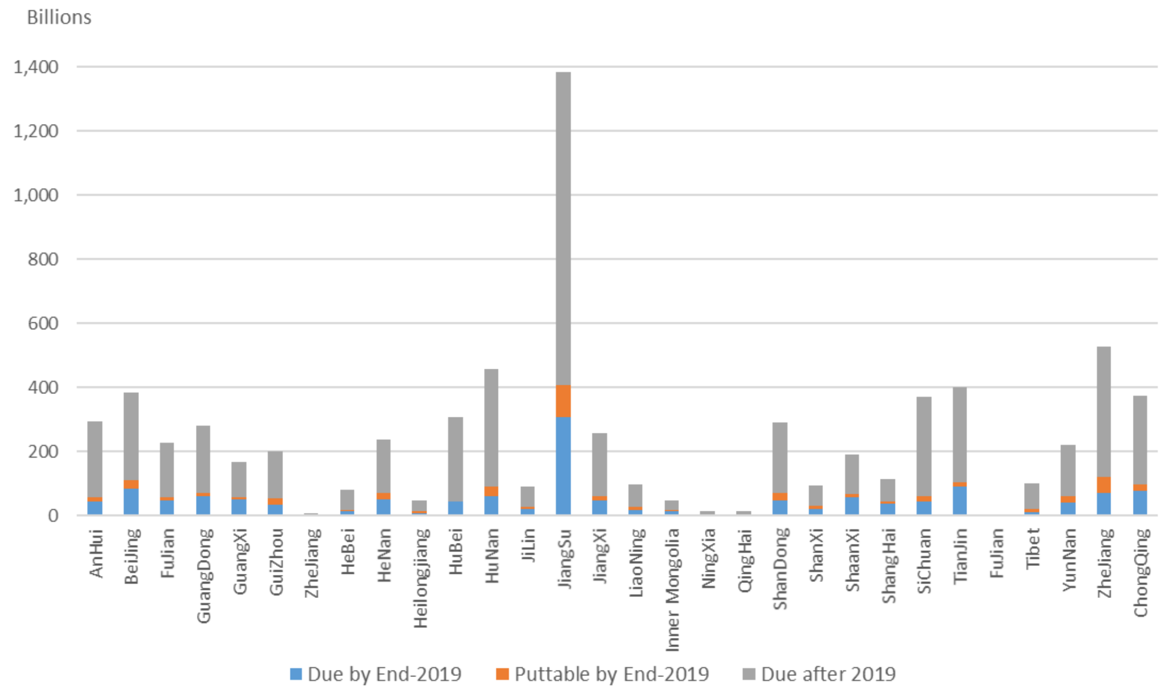
Onshore rating agencies upgraded 88 and downgraded 7 LGFVs in Jan-Nov 2018, and revised the outlook for 6 LGFVs from Stable to Negative. The rating downgrades or negative outlook revisions were mainly triggered by the regions' relatively undeveloped economy and weakened fiscal capacity where the issuers domiciled and/or the issuers' weakened standalone profiles (such as shrinking revenue, a large amount of account receivables, rapid growth of debt obligations, etc.) Although the default events of the non-standard financing instruments issued by LGFVs had an adverse impact on LGFVs' creditworthiness, their credit profiles are relatively stable compared with private corporates.

Provinces with Large Outstanding Bonds Need More Attention

The scales of outstanding bonds were different among provinces as of end-Nov 2018. Jiangsu had a total outstanding balance of RMB1,382.5billion, or 19% of total outstanding bonds at end-Nov 2018 (RMB7,371.7 billion), significantly higher than the second largest Zhejiang which accounted for 7% of the total.

The overall debt service burden in 2019 is high with RMB1,422 billion to be due this year and RMB455.4 billion of puttable bonds which may be exercised in 2019. Jiangsu has the largest volume (higher than RMB400 billion) of puttable bonds and bonds due in 2019, followed by Zhejiang, Beijing, Tianjin, Chongqing and Hunan, at about RMB100 billion each.

Exhibit 5: Outstanding Bond Breakdown by Province at End-Nov 2018



Source: Wind; *LGFV 2019 Outlook*, United Credit Ratings Co., Ltd.

Increasing Divergence of LGFVs' Credit Profiles on Eased but Still Stringent Regulation

From the bond issuance perspective, the financing policies and circumstances have been eased for LGFVs since 2H2018, which may continue in 2019 in light of the central government's needs to stimulate the economic growth by increasing infrastructure investments amid downward pressure in export and consumption sectors. LGFVs are likely to increase bond issuances to support the infrastructure investments, but they need to avoid adding more implicit government debt. The still strict regulation on LGFV financing is expected to prevent systematic risk but may lead to a credit divergence among LGFVs.

From the maturity perspective, LGFVs are facing heightened bond maturity pressure in 2019, as well as some maturing non-standard financial products, which may have an adverse impact on LGFVs' credit profiles.

For more details, please refer to the Chinese report:
《联合信用评级有限公司 2019 年城投行业信用风险展望报告》
http://www.lianhecreditrating.com.cn/News.aspx?m=20140627100707687840&n=20181228185001433049

Source: Wind; *LGFV 2019 Outlook,* United Credit Ratings Co., Ltd, published on 28 December 2018.
Note: In case of any discrepancies between the English version and the Chinese version, the Chinese version shall prevail.

Analysts
Joyce Huang, CFA
Senior Director
(852) 3462 9578
joyce.huang@lhratingsglobal.com

Zhao Lin
Associate
(852) 3462 9582
lin.zhao@lhratingsglobal.com

Business Development Contact
Joyce Chi
Managing Director
(852) 3462 9569
joyce.chi@lhratingsglobal.com

Disclaimer

Credit rating and research reports published by Lianhe Ratings Global Limited ("Lianhe Global" or "the Company" or "us") are subject to certain terms and conditions. Please read these terms and conditions at the Company's website: www.lhratingsglobal.com

A credit rating is an opinion which addresses the creditworthiness of an entity or security. Credit ratings are not a recommendation to buy, sell, or hold any security. Credit ratings do not address market price, marketability, and/or suitability of any security nor its tax implications or consequences. Credit ratings may be subject to upgrades or downgrades or withdrawal at any time for any reason at the sole discretion of Lianhe Global.

All credit ratings are the products of a collective effort by accredited analysts through rigorous rating processes. No individual is solely responsible for a credit rating. All credit ratings are derived by a credit committee vesting process. The individuals identified in the reports are solely for contact purpose only.

Lianhe Global conducts its credit rating services based on third-party information which we reasonably believe to be true. Lianhe Global relies on information including, but not limited to, audited financial statements, interviews, management discussion and analysis, relevant third-party reports, and publicly available data sources to conduct our analysis. Lianhe Global has not conducted any audit, investigation, verification or due diligence. Lianhe Global does not guarantee the accuracy, correctness, timeliness, and/or completeness of the information. Credit ratings may contain forward-looking opinions of Lianhe Global which may include forecasts about future events which by definition are subject to change and cannot be considered as facts.

Under no circumstances shall Lianhe Global, its directors, shareholders, employees, officers and/or representatives or any member of the group of which Lianhe Global forms part be held liable to any party for any damage, loss, liability, cost, expense or fees in connection with any use of the information published by the Company.

Lianhe Global receives compensation from issuers, underwriters, obligors, or investors for conducting credit rating services. None of the aforementioned entities nor its related parties participate in the credit rating process aside from providing information requested by Lianhe Global.

Credit ratings included in any rating report are solicited and disclosed to the rated entity (and its agents) prior to publishing. Credit rating and research reports published by Lianhe Global are not intended for distribution to, or use by, any person in any jurisdiction where such use would infringe local laws and regulations. Any user relying on information available through credit rating and research reports is responsible for consulting the relevant agencies or professionals accordingly to comply with the applicable local laws and regulations.

Lianhe Global is a subsidiary of Lianhe Credit Information Service Co., Ltd. The credit committee of Lianhe Global has the ultimate power of interpretation of any methodology or process used in the Company's independent credit ratings and research.