

Yancheng Oriental Investment & Development Group Co., Ltd.

Initial Issuer Report

Summary

Issuer Rating	BB+
Outlook	Stable
Location	China
Industry	Local Government
	Financing Vehicle
Date	8 January 2020

Key Figures of Yancheng and Yancheng Oriental

(RMB billion)	2017	2018
Yancheng		
GDP	508.3	548.7
GDP growth rate (%)	6.8%	5.5%
Budgetary revenue	36.0	38.1
Government fund	30.1	35.1
Transfer payment	32.4	31.3
Budgetary expenditure	74.8	84.0
Yancheng Oriental		
Assets	38.2	41.3
Equity	15.7	17.7
Revenue	1.5	1.7

Source: Statistics Bureau of Yancheng, Yancheng Oriental and Lianhe Global's calculations

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Applicable Criteria

China Local Government Financing Vehicle Criteria (16 July 2018)

Lianhe Ratings Global Limited (“Lianhe Global”) has assigned a ‘BB+’ global scale Long-term Issuer Credit Rating to Yancheng Oriental Investment & Development Group Co., Ltd. (“Yancheng Oriental”). The Outlook is Stable.

Summary

The Issuer Credit Rating reflects a high possibility that the Yancheng municipal government would provide strong support to Yancheng Oriental if needed, in light of Yancheng Oriental’s strategic position as the major developing and operating body of Yancheng Economic and Technological Development Zone (“YETDZ”) and the strong linkage between the Yancheng municipal government and Yancheng Oriental including management supervision, strategic alignment, and ongoing operational and financial support. In addition, the Yancheng municipal government may face a significant negative impact on its reputation, business, and financing activities should Yancheng Oriental encounter any operational or financial difficulties.

The Stable Outlook reflects our expectation that Yancheng Oriental’s linkage with the local government will be strengthened and it is likely to receive more supports directly from the Yancheng municipal government in the form of financial resource allocation or management supervision to sustain its ongoing business operation after the shareholding structure change to the municipal level from the prior district/zone level in August 2019.

Rating Rationale

Yancheng Municipal Government’s Full Ownership: Yancheng Oriental’s sole shareholder was changed to the Yancheng municipal government from Yancheng Economic and Technological Development Zone Management Committee (“YETDZ Management Committee”) in August 2019. Yancheng Oriental increased its registered capital to RMB 9.5 billion after the RMB 3 billion capital injection (of which RMB 1 billion was recognized as registered capital and the remaining RMB 2 billion was recognized as reserves) in 2019 prior to the shareholder change.

Strategic Development Entity: Approved and designated by the State Council as one of the national economic and technological development zones in 2010, the YETDZ was first established in Yancheng, Jiangsu in 1992. The YETDZ is centred on the Sino-Korea Industrial Park. The park was approved by the State Council in 2017 as one of the strategic industrial parks with the mission to stimulate the local economy and boost tax revenue for the local government. Yancheng Oriental acts as the major infrastructure developer in the YETDZ and the sole developer of the Sino-Korea Industrial Park.

Ongoing Government Support: We believe that the Yancheng municipal government is willing to extend strong support to Yancheng Oriental in view of its strategically important role as the major developer of the national industrial parks to support the local economic development. With the aim to further extend support to Yancheng Oriental in the construction of the Sino-Korea Industrial Park, the YETDZ Management Committee injected RMB 3 billion into Yancheng Oriental in July and August 2019. Prior to 2019, Yancheng

Oriental received government support in the form of asset/capital injections amounting to RMB 209 million, 507 million, and 61 million in 2016, 2017 and 2018, respectively.

Yancheng Oriental's linkage with the local government is strong as it is wholly owned by the Yancheng municipal government and the management team of Yancheng Oriental are all former officials from the local governments.

Weak Standalone Credit Profile with Tight Liquidity: Yancheng Oriental's standalone credit profile was weak as it had a large amount of short-term debt due within one year at end-June 2019, which totalled over RMB8.76 billion while its profitability was mainly supported by the local government's financial subsidies in the previous years. Yancheng Oriental's cash generation capacity is weak. It relied heavily on external financing and government support to maintain its business operation and capital expenditure in the previous years. We expect Yancheng Oriental's leverage will further increase in the following 12-18 months as it has a large capital expenditure plan including the construction of the Sino-Korea Industrial Park.

Rating Sensitivities

We would consider downgrading Yancheng Oriental's rating if (1) there is a perceived weakening in support from the Yancheng municipal government, particularly due to its reduced strategic importance with diminished government functions, or (2) there is a significant reduction of the Yancheng municipal government's ownership of Yancheng Oriental, or (3) there is a downgrade in our internal credit assessment of the Yancheng municipal government.

We would consider upgrading Yancheng Oriental's rating if there is an upgrade in our internal credit assessment of the Yancheng municipal government.

Operating Environment

Overview of Yancheng and Yancheng Economic and Technological Development Zone

Located in the northeast of Jiangsu Province and east of the Yellow Sea, Yancheng had a registered population of 8.2 million (resident population of 7.2 million) at end-2018. It has a land area of 16,931 square kilometres, making it the largest prefectural city in Jiangsu Province.

Automobile, machinery, textile and chemical are the four traditional pillar industries in Yancheng. Total sales from the four industries reached RMB351.2 billion in 2018, which accounted for over two-thirds of the sales amount generated from the secondary industry.

Yancheng administers 3 districts (Tinghu, Yandu and Dafeng), 5 counties (Xiangshui, Binhai, Funing, Jianhu and Sheyang) and 1 county-level city (Dongtai). In addition to the 9 county-level divisions, Yancheng also administers two economic and technological development zones, the YETDZ and Yannan High-tech Industrial Development Zone, of which both have individual fiscal settlement systems and report their fiscal budgets separately to the Yancheng municipal government. The YETDZ Management Committee, which was Yancheng's previous shareholder, acts as a dispatched agency of the Yancheng municipal government to separately manage the construction of the development zone and reports its fiscal budget to the Finance Bureau of the YETDZ, which is governed by the Finance Bureau of the Yancheng municipal government.

Yancheng's GDP and Fixed Asset Investment

(RMB billion)	2016	2017	2018
GDP	457.6	508.3	548.7
-Primary industry (%)	11.7	11.1	10.5
-Secondary industry (%)	44.8	44.4	44.4
-Tertiary industry (%)	43.6	44.5	45.2
GDP growth rate (%)	8.9	6.8	5.5
Fixed asset investment	388.3	427.8	N/A
Fixed asset investment growth rate (%)	15.1	10.2	9.4
Population (million)	7.2	7.2	7.2

Source: WIND and Finance Bureau of Yancheng

Established in 1992 and approved by the State Council as a national development zone, the YETDZ is located in the southeast of Yancheng and occupies a total land area of 200 square kilometers with a total resident population of about 200,000. Pillared on the automobile and auto-parts industry and focusing on other modern industries such as new energy autos and auto-parts, software and service outsourcing, photovoltaic and LED (Light-emitting diode), the development zone has four major industrial parks, which are Sino-Korea Industrial Park (中韩产业园), New-Energy Automobiles and Auto Parts Industrial Park (盐城新能源汽车及零部件产业园), Yancheng Comprehensive Bonded Zone (盐城综合保税区) and Yancheng Optoelectronic Industrial Park (盐城光电产业园).

A Weakened but Stabilizing Fiscal Picture

Yancheng's fiscal strength has been deteriorating for two consecutive years since 2016. Its budgetary revenue experienced a year-on-year double-digit decrease, mainly resulting from the decrease in tax revenue. The decrease of tax revenue was mainly from the decelerating growth of the automobile industry and the Chinese economy at large in the previous years. Yancheng's budget deficit is among the largest in Jiangsu Province when compared with other municipalities. It mainly relied on the local government's debt and land-use right transfer income, which was the major component of the government-managed fund, to support its budgetary expenditure. Though the budgetary revenue rebounded in 2018, it was not back to the level of 2016. In addition, Yancheng's local government debt totalled RMB101.5 billion at end-2018, which was twice the size of Yangzhou with a comparable GDP in terms of size.

Yancheng's Fiscal Condition			
(RMB billion)	2016	2017	2018
Budgetary revenue	41.5	36.0	38.1
Budgetary revenue growth rate (%)	-13.1%	-13.3%	5.8%
Tax revenue	32.5	27.2	30.5
Tax revenue (% of budgetary revenue)	78.2%	75.5%	80.1%
Government-managed fund	142.5	30.1	35.1
Transfer payment	N/A	32.4	31.3
Aggregate revenue	N/A	98.9	105.0
Budgetary expenditure	73.3	74.8	84.0
Budget deficit ¹ (%)	-76.6%	-107.8%	-120.5%

¹ Budget deficit = (1 - budgetary expenditure / budgetary revenue) * 100%

Source: Finance Bureau of Yancheng and Lianhe Global's calculations

We expect that upon the start of the operation of the high-speed railway to Shanghai and Nanjing, Yancheng's economic environment will improve in the next 2-3 years as the improved transportation system could bring more manpower to stimulate local consumption.

In addition, Yancheng Oriental follows the national development strategy promulgated by the State Council. Specifically, the State Council's 2019 No. 11 policy stipulates a new initiative to (1) support the improvement of economic structure and quality, (2) allow more autonomy in reforms (even allowing qualified state-owned entities to apply for IPOs), (3) develop vertically integrated and inclusive economies (i.e. foreign and local entities), (4) participate in the cooperation of local and foreign platforms, and (5) strengthen the sustainability and matching of resources etc. Yancheng Oriental is at the forefront of carrying out the State Council's directives. Yancheng Oriental has engaged the SK Group, the third-largest conglomerate in South Korea, to invest and develop a new energy battery project valued at RMB 10 billion in its district.

Moreover, China Baowu Steel Group Corporation Limited ("Baowu"), a leading steel producer in China, will relocate its steel productions to Yancheng from Nanjing, with the total investment being estimated at around RMB100 billion. This large-scale high-class steel production project valued at RMB 100 billion with an annual capacity of 20 million tons when completed. The steel project will include ports, coking plants, power utilities, sintering, iron and steelmaking as well as steel-rolling plants. The first stage of the project will cost RMB 50 billion over a 3-year period which has already commenced construction in Yancheng's Binhai Harbor Industrial Zone. When the steel project is completed, it will bring at least 200,000 jobs to Yancheng. We believe the steel project will likely strengthen and improve the economy of Yancheng, as well as benefit Yancheng Oriental indirectly. Baowu's



relocation of its production base will help boosting Yancheng's economic development by creating more jobs, bringing in more populations, stimulating consumption, and increasing local tax revenue.

Ownership Structure and Profile

Full State Ownership with Strong Government Supervision

Established in August 2003 under approval from the Yancheng municipal government with an initial capital of RMB150 million injected by the YETDZ Management Committee, Yancheng Oriental is the main construction and development body and financing platform for the YETDZ. The YETDZ Management Committee was established in 1992. It acts as the dispatched agency of the local government and is mainly responsible for the management affairs and attracting investments to the YETDZ. Yancheng Oriental mainly takes the role as a developer of resettlement housing, a constructor of infrastructure and an operator of the properties in the YETDZ for the YETDZ Management Committee.

The Yancheng municipal government has strong control and supervision over Yancheng Oriental, including control of the board of directors and the supervisory committee, and approvals of senior managers and major operating and financing plans. The management of Yancheng Oriental are all former officials from the local governments.

One of the Major LGFVs Responsible for Infrastructure Construction in Yancheng

Yancheng Oriental is the main investment and operating body of the YETDZ for the local government and it is responsible for the infrastructure construction work. The Yancheng municipal government and the YETDZ Management Committee injects capital or/and land to Yancheng Oriental and contracts it to take on the construction work. Since the second half of 2018, the capital injected by the government has been funded from the fiscal budgets. After the construction work is completed, the YETDZ Management Committee or the local government will buy back the projects. Yancheng Oriental normally will enjoy a gross margin of 20% on the projects as per the agreement with the local governments.

The infrastructure projects that Yancheng Oriental currently undertakes are road, bridge and some green projects with a total investment reaching RMB450 million.

As per Yancheng Oriental, the total investments in infrastructure projects in the second half of 2019 will be around RMB300-500 million. However, in the following years, its major task is to complete the redevelopment of Bufeng Town in the YETDZ, of which the total investment will be around RMB10 billion.

Strategic Importance and Government Linkage

Strong Strategic Importance to Local Government and Economy

Yancheng Oriental supports the local government in carrying out its policies, such as the Sino-Korea Industrial Park under the State Council's directive partially by acting as the financing platform, i.e. borrowing money from banks and/or capital markets and then distributing the funds to responsible third-parties to execute the related construction projects.

There was a total of 19 LGFVs under the Yancheng municipal government according to WIND Data at end-2018. Yancheng Oriental was the third-largest LGFV by asset size in Yancheng at end-2018.

Strong Linkage with the Yancheng Municipal Government

Yancheng Oriental's linkage with the local government is strong as it is wholly-owned by the Yancheng municipal government. The recent change of shareholding structure to a higher-level government, the municipal government, from the district/zone level governing body, is credit positive for Yancheng Oriental. The management of Yancheng Oriental are all former officials in the local governments.

The Yancheng municipal government has strong control and supervision over Yancheng Oriental, including control of the board of directors and the supervisory committee, and approvals of senior managers and major operating and financing plans. Yancheng Oriental's strategic planning and development have been aligned with the local government's economic and social policies.

Ongoing Government Support

Yancheng Oriental has continuously received supports from the local governments for its business operation, which are not limited to capital injections, government subsidies, allocation of land resources or assets and guidance from the local government in its daily management. The local government has also made efforts by providing funding to help Yancheng Oriental to repay its debts since 2014, which totalled RMB4.32 billion. With the aim to further extend the support of Yancheng Oriental in the construction of the Sino-Korea Industrial Park, the Yancheng municipal government approved and completed the change of shareholder of Yancheng Oriental to the Yancheng municipal government from the YETDZ Management Committee.

With the aim to further extend support to Yancheng Oriental in the construction of the Sino-Korea Industrial Park, the YETDZ Management Committee increased its registered capital to RMB 9.5 billion after the RMB 3 billion capital injection (of which RMB 1 billion was recognized as registered capital and the remaining RMB 2 billion was recognized as reserves) into Yancheng Oriental in July and August 2019 prior to the shareholder change. Prior to 2019, Yancheng Oriental also received government support in the form of asset/capital injections amounting to RMB 209 million, 507 million, and 61 million in 2016, 2017 and 2018, respectively.

Business Profile

Engaging in Various Government Functions and Commercial Segments

Operation and Profitability						
(RMB million)	2016		2017		2018	
	Revenue	Gross margin	Revenue	Gross margin	Revenue	Gross margin
Infrastructure Construction	211.2	22.3%	371.8	16.3%	107.3	16.2%
Resettlement Development	376.9	43.4%	78.4	47.6%	229.8	15.1%
Property Leasing and Management	348.1	49.6%	456.7	35.2%	549.3	42.9%
Trading Business	339.6	0.0%	464.5	1.0%	691.6	1.0%
Others	56.4	91.5%	106.8	62.9%	163.6	59.8%
Total/Weighted Average	1,332.2	32.6%	1,478.2	22.4%	1,741.6	22.5%

Source: Yancheng Oriental and Lianhe Global's calculations

1. Infrastructure Construction

Yancheng Oriental is the main investment and operating body for the local government and it is responsible for the infrastructure construction work in the YETDZ. The Yancheng municipal government and the YETDZ Management Committee inject capital or/and land to Yancheng Oriental and contract it to carry out the construction work. After the construction work is completed, the YETDZ Management Committee or the local government buys back the projects. Yancheng Oriental normally enjoys a gross margin of 20% on the projects as per the agreement with the local government.

The infrastructure projects that Yancheng Oriental currently undertakes are road, bridge and some green projects with a total investment reaching RMB450 million.

As per Yancheng Oriental, the total investments in infrastructure projects in the second half of 2019 will be around RMB300-500 million. However, in the following years, its major task is to complete the redevelopment of Bufeng Town in the YETDZ, of which the total investments will be around RMB10 billion.

2. Resettlement Development

The development of the YETDZ involves the resettlement and reallocation of the residents in the area. Yancheng Oriental also acts as the resettlement housing developer for the local government. The company normally signs an agent construction contract with its previous shareholder, the YETDZ Management Committee. The YETDZ Management Committee would then buy back the properties from Yancheng Oriental and be in charge of the sales and delivery of the resettlement housing projects.

Resettlement housing development business was the major profit contributor to Yancheng Oriental during 2016-2017 with gross margins exceeding 40% benefiting from the surging property sales price with low land costs in the previous years. However, the gross margin of the resettlement housing development was volatile. The gross margin was squeezed to 15.1% in 2018, primarily due to Yancheng Oriental's limited property development scale.

3. Property Leasing and Management

Property leasing and management income are the two major revenue sources of Yancheng Oriental. The company leases its industrial properties such as factories to industrial companies. The YETDZ Management Committee will also offer some subsidies to the tenants. In addition to industrial properties, Yancheng Oriental also has two commercial properties in Shanghai, which are managed by its subsidiaries in Shanghai. The leasing price of the two commercial properties is set according to market price.

Property management is paired with the company's leasing business of its commercial and industrial properties. In 2018, Yancheng Oriental received RMB549 million from this segment. Revenue from this segment provides a stable and sustainable income source to Yancheng Oriental.

4. Trading business

Yancheng Oriental has started its trading business since 2016, leveraging on the geographic advantage of a close proximity to the YETDZ near the Yancheng National Integrated Free Trade Zone. The company trades electrolytic copper, laterite-nickel ore, other chemical raw material and mineral products. Most of the buyers and suppliers are also trading companies located in the southeast of China and the common payment terms are COD (cash-on-delivery), which partially helps reducing the counterparty risks. The gross margin of Yancheng Oriental's trading business is low. This segment only contributed RMB7 million gross profit (gross margin: 0.99%) to the company in 2018.

5. Other Businesses

Yancheng Oriental is also involved in financial leasing, automobile sales, providing financial guarantees, and investments. At end-2018, Yancheng Oriental had already invested in six industrial funds whose industry portfolio coverage aligns with that of the core industries that the local government plans to develop in the next few years, such as new material and semiconductor industries.

Yancheng Oriental has spent RMB3.15 billion in investing in the industrial funds of which about RMB1.8 billion was invested in the funds whose target companies were not in Yancheng District. Most of the industrial funds that Yancheng Oriental invested have lockout periods ranging from 3 to 5 years, in which Yancheng Oriental cannot dispose of them to support its liquidity need. The market value of these industrial funds was at RMB4.65 billion at end-June 2019.

Financial Profile

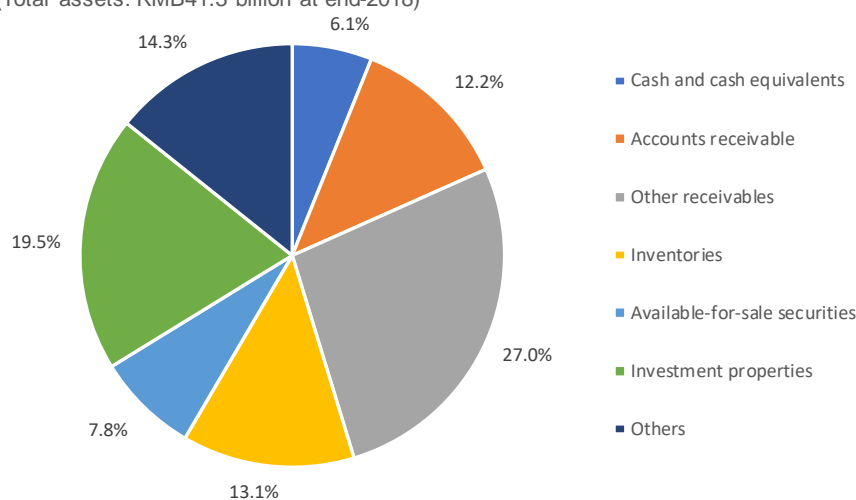
Stable Balance Sheet Growth but with Sizable Account Receivables

Yancheng Oriental's noncurrent assets experienced a substantial year-on-year increase to RMB16.1 billion at end-2018 from RMB8.7 billion at end-2016, which was mainly driven by Yancheng's increase of its stake in the industrial funds in 2017 and 2018. As per the company, Yancheng Oriental has started the investment business mainly to support the industrial developments in Yancheng. In 2018, Yancheng Oriental increased its investment in these industrial funds by RMB2.45 billion. The industry coverage of these funds is concentrated in semi-conductor, new material and other high-tech industries which the local government plans to develop in the next few years.

Yancheng Oriental's asset structure was stable in the past three years. Its equity base did not experience any substantial changes and the small increment was mainly due to the issuance of the RMB1.26 billion perpetual debt. The company's current asset accounted for over 60% of the total assets. However, Yancheng Oriental's current assets lacked liquidity as its account receivables and other receivables together constituted half of Yancheng Oriental's current assets at end-2018. Its account and other receivables were mainly (RMB12 billion) from the Finance Bureau of Yancheng Economic and Technological Development Zone ("the Finance Bureau"). For the other receivables, they were receivables due from the Finance Bureau totalling RMB6.66 billion accounting for 60%, of which over RMB 2.90 billion was overdue for 3 years at end-2018. The local government resumed the titles on some pieces of land from Yancheng Oriental. This brought RMB 6 billion of other receivables under Yancheng Oriental. The Finance Bureau has issued a repayment plan in which it promises to repay the RMB12 billion from its annual fiscal revenue from 2018 to 2022.

Asset Breakdown

(Total assets: RMB41.3 billion at end-2018)

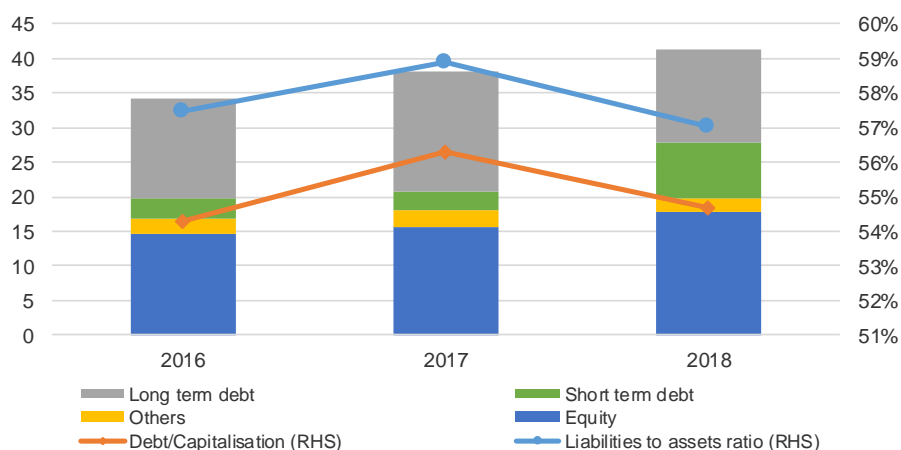


Source: Yancheng Oriental's annual report

Financial Leverage

The company's total debt remained at a similar level at-end 2018 when compared to 2017, but its long-term debt amount decreased to RMB12.77 billion (from RMB 17.39 in 2017) while its short-term debt increased to RMB 6.5 (from RMB 1.72 in 2017).

Capital Structure from 2016 to 2018



Source: Yancheng Oriental and Lianhe Global's calculations

Tight Liquidity

Yancheng Oriental's liquidity was tight. It had RMB8.76 billion debt due within one year, which accounted for 35.5% of its total debt at end-June 2019. Yancheng Oriental had unrestricted cash of RMB 2.78 billion (out of total cash of RMB 5.78 billion) and a total credit line of RMB 15.4 billion of which approximately RMB 5.5 billion was available at end-June 2019.

Debt Maturity Profile at end-June 2019

(RMB million)	Amount	Percentage
3Q2019	3,184	12.9%
4Q2019	3,340	13.5%
1Q2020	1,299	5.3%
2Q2020	940	3.8%
3Q2020	2,160	8.7%
4Q2020	657	2.7%
2021 and thereafter	13,139	53.1%
Total	24,719	100.0%

Note: The amount in the debt maturity profile excludes finance leases and bill payables

Source: Yancheng Oriental and Lianhe Global's calculations

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