Zhengzhou Urban Construction Investment Group Co., Ltd.

Initial Issuer Report

Summary	
Issuer Rating	A-
Outlook	Stable
Location	China
Industry	Local Government Financing Vehicle
Date	17 October 2019

Key Figures of Zhengzhou and ZZC

(RMB billion)	2017	2018
Zhengzhou		
GDP	913.0	1,014.3
GDP growth rate (%)	8.2	8.1
Budgetary revenue	105.7	115.2
Government fund	107.3	143.5
Transfer payment	31.2	35.5
Budgetary expenditure	151.5	176.3
ZZC		
Assets	34.8	37.0
Equity	18.2	18.2
Revenue	1.1	1.2

Source: Zhengzhou Bureau of Statistics, Zhengzhou Finance Bureau, ZZC 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-' global scale Long-term Issuer Credit Rating to Zhengzhou Urban Construction Investment Group Co., Ltd. ("ZZC"). The Outlook is Stable.

Summary

The Issuer Credit Rating reflects a high possibility that Henan's Zhengzhou municipal government would provide strong support to ZZC if needed. This mainly considers the Zhengzhou government's full ownership of ZZC, the high strategic importance of ZZC to Zhengzhou in the municipal infrastructure construction and maintenance, and the strong linkage between the Zhengzhou government and ZZC, including management supervision, strategic alignment, and ongoing operational and financial support. In addition, the Zhengzhou government may face significant negative impact on its reputation and business and financing activities should ZZC encounter any operational or financial difficulties.

The Stable Outlook reflects our expectation that ZZC's strategic importance would remain intact while the Zhengzhou government will continue to ensure ZZC's stable operation.

Rating Rationale

Zhengzhou Government's Full Ownership: The Zhengzhou government has 100% ownership of ZZC via the State-owned Assets Supervision and Administration Commission of Zhengzhou ("Zhengzhou SASAC") which is appointed by the government to supervise state-owned entities. Zhengzhou SASAC is the only shareholder of ZZC through its fully-owned Zhengzhou Real Estate Group Co., Ltd. ("Zhengzhou Real Estate"). ZZC was established in December 2007 with an initial capital of RMB10 million and subsequently increased its registered capital to RMB1 billion as of end-June 2019.

High Strategic Importance: ZZC is one of Zhengzhou's major investment and financing platforms and has undertaken various businesses including municipal infrastructure construction and maintenance, hotel operations and commodity trading to support the economic development in Zhengzhou. It has extended its infrastructure project scope from roads and bridges to shantytown renovation, public service facilities, and ecological and environmental governance.

ZZC is mainly responsible for the construction and investment of municipal infrastructure projects within the Fourth Ring of Zhengzhou City. Major completed projects include the first phase of Beijing-Guangzhou Expressway Project, Jinshui Road West Extension Project, East Third Ring Expressway Project, etc. Projects which are currently under construction include Zhengzhou Grand Theatre, Zhengzhou Citizen Activity Centre, Jialu River Ecological Greening Project, and Zhongyuan New District Shantytown Renovation.

Government Supervision and Strategic Alignment: The Zhengzhou government and Zhengzhou SASAC have strong control and supervision over ZZC, including control of the board of directors and the supervisory committee, senior management appointments, and major strategic, investment and financing planning. ZZC's business operation and development have been aligned with the government's economic and social policies. As one of the designated national central cities in the central region of China, Zhengzhou has devoted to optimise its economic structure and strengthen the transportation connections and logistic services to promote urban and rural developments.

Ongoing Government Support: ZZC has received capital and asset injections from the Zhengzhou government and related government entities since its establishment. The injections include road maintenance right and municipal infrastructure such as roads and bridges. The Zhengzhou Finance Bureau has also supported ZZC's operations through various forms of cooperation, e.g. build-transfer contracts, government procurement of services and public–private partnership projects.

Strong Economy and Fiscal Strength Underpin Zhengzhou: Ongoing economic development, industrialisation and urbanisation supported Zhengzhou's high GDP growth rate which was 7.9% in 1H2019 (8.1% in 2018), compared with Henan province's 7.7% and China's 6.3%. The service industry has become the main GDP growth driver with the tertiary industry (the service sector) accounting for the largest 54.9% of Zhengzhou's 1H2019 GDP, followed by the secondary industry's (comprising manufacturing and construction) 43.8%.

Zhengzhou's aggregate fiscal revenues are mainly derived from stable budgetary revenue with tax revenue accounting for above 70% between 2016-2018 and more volatile government fund income. Subsidies from higher government authorities have been relatively small. Zhengzhou's debt ratio (i.e. total government debt divided by aggregate revenue) decreased to a moderate level of 60.6% in 2018 from 88.7% in 2016, while its budget deficit became bigger due to fast growing budgetary expenditure during the period.

Moderately Weak Financial Matrix: ZZC's earnings generation capability has been weak given its focus on public projects with limited commercial-oriented activities. The reliance on debt financing to support its capital expenditure drove up ZZC's financial leverage (total liabilities to assets) to 50.9% at end-2018 from 37.8% at end-2016, mitigated by its sufficient liquidity with cash on hand and standby credit facilities. RMB2.2 billion of outstanding debt will be due within one year as of end-June 2019, compared with ZZC's unrestricted cash position of RMB5.5 billion, unused bond quota of RMB5.4 billion, available credit lines of RMB41.7 billion and other debt financing vehicles of RMB4 billion.

Rating Sensitivities

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

We would consider upgrading ZZC's rating if there is an upgrade in our internal credit assessment on the Zhengzhou government.

Operating Environment

Industrialisation and Urbanisation Underpin Zhengzhou's Strong GDP Growth

Zhengzhou is the capital city of Henan province and a transport hub for railways, highways and aviation in China. The Zhengzhou-Europe International Block Train connecting Zhengzhou to Europe further supports Zhengzhou to become the main collecting and distributing centre and the transit point for goods in central, northwest, north and northeast of China. As one of the designated national central cities, Zhengzhou plays an important role to foster economic development of the central region in China and has devoted to optimise its economic structure and strengthen the transportation connections and logistic services to promote urban and rural developments.

Ongoing economic development, industrialisation and urbanisation supported Zhengzhou's high GDP growth rate which was 7.9% in 1H2019, compared with Henan province's 7.7% and China's 6.3%. The service industry become the main GDP growth driver with the tertiary industry (the service sector) accounting for the largest 54.9% of Zhengzhou's 1H2019 GDP, followed by the secondary industry's (comprising manufacturing and construction) 43.8%.

Zhengzhou's population had been growing with a total population of 10.1 million and an urban population of 7.4 million as of end-2018. Zhengzhou's total GDP in 2018 and 1H2019 was the highest among all the cities in Henan province and was more than twice the GDP of Luoyang city (ranked second of all cities in Henan province). GDP per capita of Zhengzhou was RMB101,349, about 2.0x the amount of Henan and 1.4x of China in 2018.

Zhengzhou's GDP and Fixed Asset Investment

(RMB billion)	2016	2017	2018	1H2019
GDP	811.4	913.0	1,014.3	510.7
-Primary industry (%)	1.9	1.7	1.5	1.3
-Secondary industry (%)	46.8	46.5	43.9	43.8
-Tertiary industry (%)	51.3	51.7	54.7	54.9
GDP growth rate (%)	8.5	8.2	8.1	7.9
Fixed asset investment	699.9	757.3	839.9	-
Fixed asset investment growth rate (%)	11.3	8.2	10.9	8.4
Population (million)	9.7	9.9	10.1	-

Source: Zhengzhou Bureau of Statistics

A Moderate Debt Level on Strong Fiscal Revenue

Zhengzhou's aggregate fiscal revenues are mainly derived from stable budgetary revenue with tax revenue accounting for above 70% between 2016-2018 and more volatile government fund income. Subsidies from higher government authorities have been relatively small. We expect ongoing economic development to support persistent growth in Zhengzhou's budgetary revenue, while the government policies in the property market and land transfer planning remain key factors affecting the government fund income.

Zhengzhou's debt ratio (i.e. total government debt divided by aggregate revenue) decreased to a moderate level of 60.6% in 2018 from 88.7% in 2016, while its budget deficit widened due to fast growing budgetary expenditure during the period. Zhengzhou had RMB178.3 billion outstanding debt at end-2018, including RMB117.9 billion of general obligations and RMB60.5 billion for special projects.

Zhengzhou's Fiscal Condition

(RMB million)	2016	2017	2018
Budgetary revenue	101,120	105,670	115,210
Budgetary revenue growth rate (%)	14.3	9.6	9.0
Tax revenue	72,330	77,520	85,950
Tax revenue (% of budgetary revenue)	71.5	73.4	74.6
Government fund income	83,590	107,258	143,540
Transfer payment	31,380	31,170	35,472
Aggregate revenue	216,600	244,208	294,482
Budgetary expenditure	132,150	151,490	176,330
Budget deficit[1] (%)	-30.7	-43.4	-53.1

*[1] Budget deficit = (1-budgetary expenditure / budgetary revenue) * 100%*
Source: Zhengzhou Finance Bureau and Lianhe Global's calculations

Ownership Structure and Profile

Full State Ownership with Strong Government Supervision

ZZC was established as a fully stated-owned entity in December 2007 under the No. 136 [2007] of the Zhengzhou Municipal People's Government with an initial capital of RMB10 million. ZZC increased its registered capital to RMB1 billion as of end-June 2019. Zhengzhou SASAC is the only shareholder with 100% ownership through its fully-owned Zhengzhou Real Estate and the Zhengzhou government is the ultimate controller.

The Zhengzhou government and Zhengzhou SASAC controll and supervise ZZC’s strategic planning, business operation and investment and financing activities mainly through the board of directors and the supervisory committee as well as management appointments. Zhengzhou SASAC has appointed two out of the three members on ZZC’s board of directors. The supervisory committee of ZZC consists of five members and three of them are also appointed by Zhengzhou SASAC.

One of the Major LGFVs Responsible for Infrastructure Construction and Maintenance in Zhengzhou

ZZC is a state-owned LGFV under the Zhengzhou government with total assets of RMB40.5 billion at end-June 2019. ZZC’s business focuses on the municipal infrastructure construction and maintenance, supplemented by hotel operations, commodity trading, etc. The main revenue sources are municipal infrastructure asset maintenance income, engineering and infrastructure construction revenue and hotel business income. With advantages in financing and project execution and management, we consider that ZZC has developed a good capability to take on major municipal infrastructure projects, especially in road and bridge construction.

As one of Zhengzhou’s major investment and construction platforms, Zhengzhou’s economic and financial conditions and future planning have a significant impact on ZZC’s development. Ongoing demands for unban infrastructure construction along with Zhengzhou’s economic expansion have provided a favourable environment for ZZC’s business development.

Strategic Importance and Government Linkage

High Strategic Importance to Local Government and Economy

ZZC is one of Zhengzhou's major investment and financing platforms and has undertaken various businesses including municipal infrastructure construction and maintenance, hotel operations and commodity trading to support the economic development in Zhengzhou. It has further extended its infrastructure project scope to shantytown renovation, public service facilities, ecological and environmental governance, etc.

Strong Linkage with Zhengzhou Government

Zhengzhou SASAC has strong control and supervision over ZZC, including control of the board of directors and the supervisory committee, senior management appointments, and major strategic, investment and financing planning. ZZC's business operation and development have been aligned with the government's economic and social policies.

Ongoing Government Support

ZZC has received capital and asset injections from the Zhengzhou government and related government entities. The asset injections include road maintenance right and municipal infrastructure such as roads and bridges. In total, ZZC received asset and capital injections of RMB17,935 million from 2009 to 2018, including RMB16,945 million asset injections and RMB990 million capital injections.

The Zhengzhou Finance Bureau has supported ZZC's operations through various forms of cooperation, e.g. build-transfer contracts, government procurement of services and public–private partnership projects. The Zhengzhou Finance Bureau paid a total of RMB6,259 million by purchasing the completed infrastructure from ZZC in 2010-2015. The Zhengzhou Finance Bureau also paid a total of RMB4,747 million for infrastructure asset maintenance and RMB1,390 million of government subsidies to ZZC between 2010 and 2018.

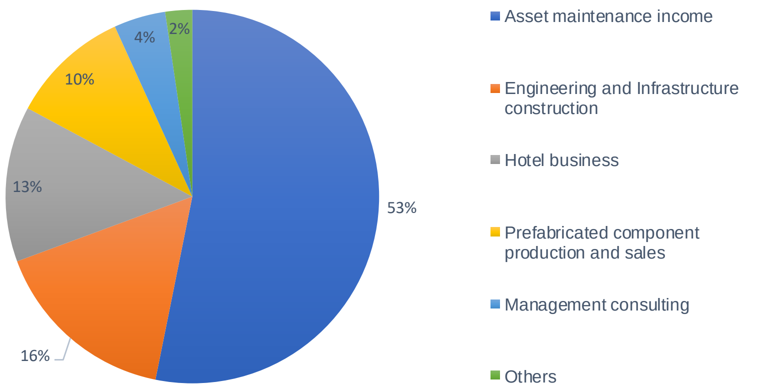
Business Profile

Engaging in Various Government Functions with Limited Commercial Business

ZZC reported a moderate year-on-year growth of 8% in revenue to RMB1,182 million in 2018. Asset maintenance income stayed steady at RMB629 million, accounting for the biggest share of 53.2% of the total revenue in 2018. Engineering and infrastructure construction revenue was the second largest of RMB192 million, followed by the hotel business income of RMB159 million in 2018. ZZC's 1H2019 revenue reached a year-on-year growth rate of 36.1% to RMB661 million, mainly due to the strong increase in prefabricated component production and sales.

Revenue Breakdown

(Total revenue: RMB1,182.5 million in 2018)



Source: ZZC's annual report and Lianhe Global's calculation

Municipal Infrastructure Construction and Maintenance

ZZC is mainly responsible for the construction and investment of municipal infrastructure projects such as urban roads and bridges within the Fourth Ring of Zhengzhou City. Major completed projects include the first phase of Beijing-Guangzhou Expressway Project, Jinshui Road West Extension Project, East Third Ring Expressway Project, etc. ZZC has further expanded its project scope to shantytown renovation, public service facilities, and ecological and environmental governance. Major projects currently under construction include Zhengzhou Grand Theatre, Zhengzhou Citizen Activity Centre, Jialu River Ecological Greening Project, and Zhongyuan New District Shantytown Renovation. Total investment amount for completed, in-progress and under planning infrastructure projects would be about RMB58.9 billion as per ZZC's estimate at end-June 2019.

ZZC has also assumed municipal infrastructure assets from the Zhengzhou and related government entities and is responsible for their maintenance. The acquired assets were classified as other non-current assets (RMB14.6 billion at end-2018) on ZZC's balance sheet. In 2017, ZZC acquired Zhengzhou Cheng Fa Huan Tong Industry Ltd. to take on the revenue royalties of Zhengzhou Third Ring Road Project (RMB5.1 billion at end-2018 and recognised as intangible assets on ZZC's balance sheet) and to be responsible for the infrastructure's operation and maintenance.

Hotel Operations

ZZC's hotel business is mainly carried out by the two subsidiaries, Huanghe Hotel Zhengzhou and Songshan Hotel Zhengzhou, which were injected by the Zhengzhou government in 2014. Huanghe Hotel Zhengzhou, opened in 1975 and renovated in 1995, has 300 rooms, 28 restaurants, and 15 meeting rooms. Songshan Hotel Zhengzhou, opened in 1958 and renovated in 2013, has 953 beds, 14 restaurants, and 22 meeting rooms. ZZC's hotel operations contributed steady revenue achieving RMB159 million and RMB153 million in 2018 and 2017, respectively.

Trading and Other Businesses

ZZC mainly conducts its other businesses (including trading, prefabricated components, and consultants) and generates revenue associated with its main business – municipal infrastructure construction and maintenance. The trading business is primarily undertaken by its subsidiary Henan Cheng Tou Cheng Zhu Industry Ltd. and its products are mainly building materials. The customers of the trading business are mainly large state-owned enterprises engaging in construction projects. Urban Construction Research Centre and its subsidiary Henan Urban Construction Prebuild Ltd. are responsible for the production, sales and installation of prefabricated components and the main products are concrete components.

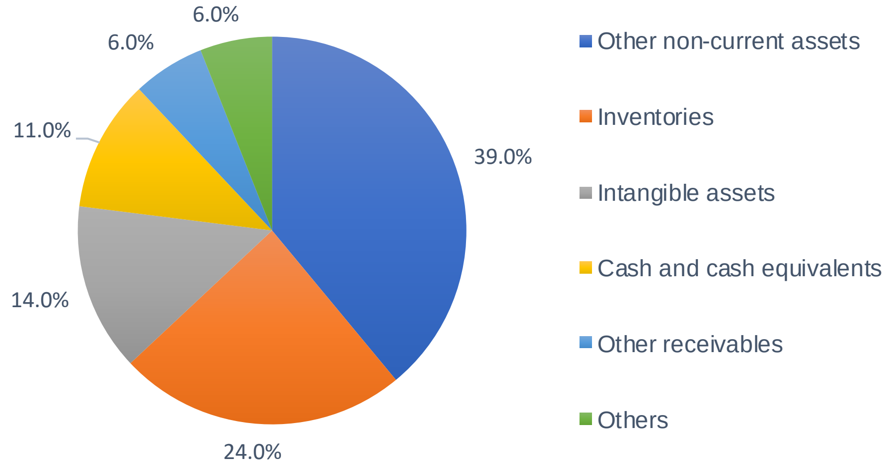
Financial Profile

Strong Asset Growth

ZZC's total assets increased about 27% to RMB37 billion at end-2018 from RMB29 billion at-end 2016 mainly due to ongoing investments in public infrastructure projects and the acquisition of Zhengzhou Cheng Fa Huan Tong Industry Ltd.

Eighteen infrastructure projects (including roads, tunnels, the grand theatre, the citizen activity centre, and shantytown renovations) under development constituted most of ZZC's inventories as of end-2018. The inventories increased 62.7% year on year to RMB8.9 billion at end-2018, mainly due to the increase in development cost of undertaken infrastructure projects. As of end-2018, ZZC had RMB5.1 billion of intangible assets (the profit right of Zhengzhou Third Ring Road Project) arising from the acquisition of Zhengzhou Cheng Fa Huan Tong Industry Ltd. and RMB14.6 billion of other non-current assets which were municipal infrastructure assets. Other receivables were RMB2.4 billion at end-2018, most of which were exposures to government-related parties with long payment term of over 1 year.

Asset Breakdown
(Total assets: RMB37.0 billion at end-2018)

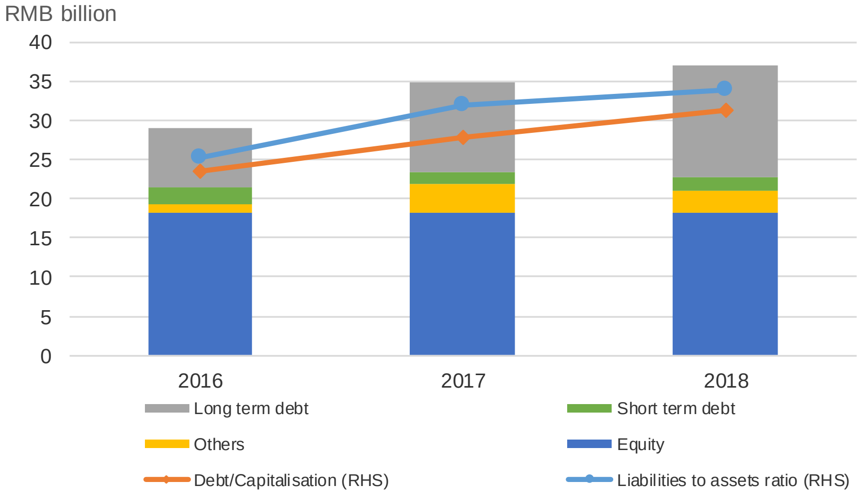


Source: ZZC's annual report

Increasing Financial Leverage

ZZC's financial leverage (total liabilities to assets) increased to 50.9% at end-2018 from 37.8% at end-2016 as it notably relied on debt funding to support its capital expenditure. We expect that ZZC will continue to raise debt to support future capital expenditure (about RMB15.5 billion for 2019-2021 as per its estimate), which would drive up its leverage further. ZZC's liabilities were mainly composed of long-term loans, bonds payables, account payables and long-term loans due within one year, accounting for 63%, 13%, 11% and 9%, respectively, of total liabilities (RMB18.9 billion, including total debts of RMB16.1 billion) at end-2018.

Capital Structure from 2016 to 2018



Source：ZZC and Lianhe Global's calculation

Weak Earnings Generating Capability

The structure of ZZC's revenue remained largely unchanged between 2016 and 2018, with asset maintenance income remained the main source of revenue. Engineering and infrastructure construction revenue was the second largest of RMB192 million in 2018, followed by the hotel business income of RMB159 million. As ZZC mainly focuses on public projects with limited commercial-oriented activities, earnings generation capability has been weak.

Operation and Profitability

(RMB million)	2016 Revenue	2016 Gross margin	2017 Revenue	2017 Gross margin	2018 Revenue	2018 Gross margin
Management consulting	4.2	86.6%	9.6	100.0%	52.9	99.1%
Asset maintenance income	615.8	29.7%	628.7	37.4%	628.7	37.4%
Engineering and infrastructure construction	175.5	54.5%	137.5	19.5%	191.6	21.9%
Hotel operation	150.5	72.5%	153.3	76.6%	159.3	77.6%
Trading	84.3	6.5%	100.7	14.7%	24.7	17.8%
Technical service	11.0	99.2%	4.1	100.0%	2.9	100.0%
Prefabricated component production and sales	164.2	10.5%	61.5	5.7%	122.5	-5.1%
Others	1.1	84.5%	-	-	-	-
Total/weighted average	**1,206.7**	**35.3%**	**1,095.4**	**37.6%**	**1,182.5**	**38.4%**

Source: ZZC and Lianhe Global's calculations

Sufficient Liquidity

ZZC has access to multiple funding channels, including bank loans, non-bank loans, and bond issues for funding to support its debt repayment and business development. Its overall liquidity is sufficient to support ZZC's debt repayments, as it had unrestricted cash of RMB5.5 billion, unused bond quota of RMB5.4 billion, credit facilities of RMB59.0 billion (RMB41.7 billion unused), and other debt financing vehicles of RMB4 billion at end-June 2019, compared with its outstanding debt of RMB2.2 billion due within one year.

ZZC's interest coverage (EBITDA over Interest) was moderate at an average of 1.12x in 2016-2018. Its financing cost was primarily in the range of 4.48%-7.8%, and the average financing cost for outstanding bonds was about 5% as of end-June 2019.

Debt Maturity Profile at End-June 2019

(RMB million)	Amount	Percentage
3Q2019	196	1.0%
4Q2019	351	1.8%
1Q2020	934	4.8%
2Q2020	675	3.4%
3Q2020	1,332	6.8%
4Q2020	499	2.5%
2021	3,603	18.3%
2022	3,631	18.5%
2023 and thereafter	8,433	42.9%
Total	**19,654**	**100%**

Source: ZZC and Lianhe Global's calculations

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