

Rating Methodology for China's Local Government Financing Vehicles

Summary

This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited (“CCXAP”) applies to China’s local government financing vehicles (“LGFVs”). An LGFV is the regional state-owned enterprise with investment and financing functions in China, mainly constituted as an urban construction and investment company. The aim of establishing LGFVs is to satisfy the financing and investment needs for local governments.

The credit rating of LGFVs is determined by two major factors, which are the credit profile of the local government and the credit profile of the rated LGFV. Given the LGFV’s function, position and business type and its relationship with the local government, the credit profile of the local governments forms the foundation of that of the LGFVs. The credit profile of the local governments measures the ability and willingness of debt servicing. The credit profile of the LGFVs consists of three aspects such as financial performance, business operation and corporate governance.

CCXAP evaluates the credit profile of local governments and the LGFVs respectively, and then considers the credit relationship between the two. The credit rating of local governments is the cap of that of LGFVs.

This rating methodology introduces the key determinants for rating LGFVs. CCXAP assigns credit ratings to them using its rating scale.

Introduction of Rating Methodology

The key rating determinants are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summarized guidance for the important factors used in assigning ratings, but it does not include every aspects of rating consideration. As a result, the mapped rating may not match the final rating of each company.

In this rating methodology for determining the creditworthiness of LGFVs, there are three key rating factors comprising six secondary factors as follows.

| Rating Factors | Secondary Factors | Tertiary Factors |
|-----------------------|--------------------------------------------------|-----------------------------------------------------------------------------------------------|
| Financial Performance | Capital Structure, Asset Quality, and Liquidity | Total Asset Total Equity Total Capitalization Ratio Cash/Short-term Debt |
| | Operating Performance and Payment Collection | Account Receivable/Total Asset Operating Profit Operating Cash Inflow/Total Revenue |
| | Refinancing Ability | External Guarantee/Net Asset Restricted Asset/Total Asset |
| Corporate Governance | Management and Control Information Disclosure | |
| Business Operation | Stability and Sustainability | |

Key Rating Determinants

1. Determining the credit rating of the local government of rated LGFV

Refer to the “Rating Methodology for Regional and Local Governments” published in June 2017.

2. Determining the credit rating of LGFVs

Rating factors and sub-factors are discussed in details in this section, including the rationale and measurement of these factors and how they will affect the rating.

(1) Financial Performance

The factors of financial performance are based on the LGFV’s characteristics of financial accounting. We evaluate the financial management by the factors such as capital structure, asset quality, liquidity, operating performance and payment collection, and refinancing ability.

(a) Capital Structure, Asset Quality and Liquidity

From the perspective of capital structure, since LGFVs are responsible for infrastructure construction and land development, the proportion of inventories, projects under construction and intangible assets is relatively high. In addition, due to the asset injection from local governments to LGFVs, the scale of capital reserves is relatively large. Overall, the scale of total asset and total equity are important considerations.

From the perspective of debt structure, the proportion of long-term debt is high for LGFVs, in line with the long construction period of infrastructure projects. Furthermore, the capitalized interest expenditure is higher than financial interest expenditure. The total capitalization ratio can help evaluate the debt-serving capability of LGFVs from the perspective of interest-bearing liabilities.

(b) Operating Performance and Payment Collection

In the view of profitability of LGFVs, the asset turnover and return on equity is relatively low. The revenue mainly generates from agent construction and land development, which is volatile. The operating profit is low or even negative, while the profit mainly generates from the non-operating profit such as subsidies of local governments. Therefore, the operating profit can reflect the profitability of LGFVs.

From the perspective of accounts receivable and payable, the proportion of current accounts is large, of which other receivables and payables are mostly related to the local government or other state-owned enterprises. The proportion of accounts receivable to total asset is large, showing a certain difficulty of payment collection from government.

From the perspective of cash flow, the operating cash flow is relatively weak, and the investing and financing cash flow is relatively large. The ratio of cash inflow from selling goods and providing services to total revenue can reflect the cash flow generating ability of LGFVs from main business.

(c) Refinancing Ability

The refinancing ability depends on the relationship between LGFVs and financial institutions such as banks, as well as the convenience of issuing bonds. The considerations include credit facilities and liquidity supports from banks and track record of issuing bonds. In practice, we choose the ratios of external guarantee/net asset and restricted asset/total asset to measure the refinancing ability of LGFVs.

(2) Corporate Governance

The corporate governance of LGFVs reflects the standardization and compliance of operational management. CCXAP considers two factors of management and control ability and information disclosure.

(a) Management and Control

CCXAP considers the management and control ability from the perspective of finance, strategy and operation of LGFVs. This ability embodies in the management and control over subsidiaries, the independency and effectiveness of operations, as well as the normalization of financial and fund management. The factor of management and control ability is a significant factor to evaluate the corporate governance. LGFVs with strong management and control ability have proper risk management.

(b) Information Disclosure

Information disclosure means that LGFVs disclose the company information to investors and the public through prospectus, announcement, regular financials and temporary reports. The quality, timeliness and effectiveness of information disclosure are particularly important. LGFVs with complete information disclosure have normative corporate governance.

(3) Business Operation

CCXAP assesses the business operation of LGFVs by considering the stability and sustainability of businesses.

(a) Stability and Sustainability

In the evaluation of business operation, it is important to consider the structure and progress of future transition for LGFVs, including the original functions and businesses, the business scale, and any change of land development and construction model after the transition. We also assess the current situation of operating business and any new sources of operating income.

3. Support willingness of local government

In the evaluation of the relevance between local governments and LGFVs, we assess the probability that the local government is willing to support the LGFV to ensure zero or low default probability. We mainly consider three factors including the positioning, the business importance and the political importance of an LGFV to its local government.

(1) Positioning of LGFVs

(a) The degree of financing function of LGFVs

The Chinese local governments will raise capitals through issuing provincial government bonds in the future. If part of the capitals is raised through LGFVs, it indicates that the local governments rely on the financing function of the LGFVs, so the financing function of LGFVs is still important to the local governments.

(b) The importance of investment projects to the region

The importance of investment project to the region is another significant factor to decide the positioning of LGFVs. The positioning of LGFVs is important to determine the supporting level from the local governments.

(c) The preservation of public services function in the future

The preservation of public services function in the future, namely the strength of public services function of LGFVs, will affect the supporting level from the local governments.

(2) Business Importance

(a) The proportion of public services projects

The public services of LGFVs imply the government support. If the source of business is from the projects settled by the government, e.g. a large proportion of business income from land development and infrastructure construction, LGFVs are highly dependent on the income from local governments.

(b) The contribution of LGFV's operating business to local government's fiscal revenue

In order to support the development of LGFVs, the local governments inject part of operating asset or equity shares into LGFVs. An LGFV obtain part of the important business sectors, operating as subsidiaries of the LGFV. If these business sectors play an essential role in the regional economy, especially having a great impact on the local government's fiscal revenue or the people's livelihood, then the LGFV's business is important to the local government and the local government is more willing to support the LGFV.

(c) The influence of LGFV's land business on local government's fund revenue

If the proportion of land business is relatively large, the influence on the local government's fund revenue is relatively great. When potential default of the LGFV occurs, the possibility of support from the local government is higher.

(3) Political Importance

From the perspective of political factors, whether the local governments support the LGFVs depends on the political influence if no bailout for default.

(a) The influence on financing environment if no bailout

If the local government does not bailout for LGFV default, market investors may lose confidence on the governmental credit and become worry about the regional risk, which hurdles corporate financing and increase funding cost. If no bailout for default causes a negative influence on the financing environment in the region, the possibility that the local government decides to support the LGFV is higher.

(b) The influence on public opinion if no bailout

If the local government does not bailout for LGFV default, the press and the public may pay attention to the governmental credit and the regional risk. If the local government indicates that they do not welcome the negative influence of the public opinion on the financing environment, the possibility that the local government decides to support the LGFV is higher.

(c) The influence on political stance if no bailout

Under the current political system, from the perspective of political cost, the policymakers of the local government will be under a considerable political pressure if no bailout for default. This can be observed from the attitude of local government and the words and actions of relevant government officials. In addition, the political background of local government officials and their previous experience are also important considerations.

4. Support strength of local government

From the perspective of support strength of the local government, CCXAP evaluates the amount of supporting resources that an LGFV would receive from the local government to ensure no default.

(1) Local Government Debt Swap

Local government debt swap means that the local government reduces the debt servicing pressure through borrowing new debt for repaying previous debt under appropriate interest rates. The scale and percentage of debt swap varies for regions and LGFVs, and thus the level of support provided by local government debt swap also varies for the LGFVs. Higher the debt amount and swap proportion, greater the support strength of local governments.

(2) Resource Allocation

Based on the current political system, the local governments have a relatively large amount of on- and off-balance sheet resources, which could be allocated for the debt servicing of LGFVs. The availability of resources and the degree of resource allocation are the important determinants to evaluate the support strength of local governments.

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China Chengxin (Asia Pacific) Credit Ratings Company Limited

Address: Suites 805-808, 8/F, Jardine House,
1 Connaught Place, Central, Hong Kong

Website: www.ccxap.com

Email: info@ccxap.com

Tel: +852-2860 7111

Fax: +852-2868 0656