中誠信亞太
CCXAP

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Rating Methodology for China's Local Infrastructure Investment and Financing Companies

Summary

This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") applies to China's local infrastructure investment and financing companies ("LIIFCs"). An LIIFC is a local state-owned enterprise with construction, investment, and financing functions regarding the regional or local infrastructures in China.

The credit rating of LIIFCs is determined by two major components: the baseline credit assessment ("BCA") of LIIFCs; and the degree of extraordinary support from local governments[1]. The BCA of LIIFCs consists of three aspects, namely financial performance, business operation, and corporate governance and management. The extraordinary support refers to the willingness of local governments to provide support based on the importance of LIIFCs, as well as their abilities to provide support based on their resource utilization and allocation capability. The credit ratings of LIIFCs are therefore based on their BCAs with their possible uplifts attributable to extraordinary support.

This new rating methodology replaces the "Rating Methodology for Local Government Financing Vehicles" published by CCXAP in June 2017. We use the term "local infrastructure investment and financing companies" to replace original term "local government financing vehicles", as the new term can better reflect the business functions of this sector. The new methodology removes three rating factors, but includes asset quality as a new rating factor. Also, we clarify the definition and measurement of rating factors in the new methodology in order to provide more transparency. The revision of rating methodology could cause rating upgrade or downgrade of some rated entities.

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

[1] For the methodology of local government, please refer to the "Rating Methodology for Regional and Local Governments" published in May 2020.

Introduction of Rating Methodology

The key rating determinants are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summary of guidelines that contains the important factors used in assigning ratings, but it does not include exhaustive aspects of rating considerations. As a result, the mapped rating may not match the final rating of each rated entity.

In this rating methodology for determining the BCA of LIIFCs, there are three key rating factors comprising five secondary factors as follows:

Rating Factors	Secondary Factors	Tertiary Factors
Business Operation	Stability and Sustainability	
Corporate Governance and Management	Corporate Governance and Management Ability	
Financial Performance	Capital Structure and Asset Quality	Total Equity Total Capitalization Ratio Asset Quality
	Operating Efficiency	Operating Profit Cash Collection Ratio
	Liquidity	Cash/Short-term Debt Restricted Asset/Total Asset

After the baseline credit assessment, we will evaluate the likelihood of receiving extraordinary support, which is a key consideration in determining the credit quality of LIIFCs given their business nature and relatively weak BCA.

Key Rating Determinants

1. Baseline Credit Assessment

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

(1) Business Operation

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

(i) Stability and Sustainability

In the evaluation of business operation, it is important to consider the structure and progress of future business transition for LIIFCs, including the original functions of the 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. We believe a stable and sustainable business profile could provide a solid cash flow to cover debt obligations, which is credit positive to LIIFCs. Business transition can be either positive or negative to LIFFCs' credit profile as new businesses can improve the revenue sources but can also enlarge investment and capital expenditure risks. Therefore, we will evaluate the business transition case by case.

(2) Corporate Governance and Management

The corporate governance and management of LIIFCs is a crucial factor in the evaluation of their credit profiles.

(i) Corporate Governance

For the evaluation of corporate governance, CCXAP assesses the corporate structure, independence of practices, and decision-making processes of LIIFCs. A well-established and standardized corporate governance with independent decision-making processes as well as fair and transparent operating procedures can help LIIFCs mitigate operational risks.

(ii) Management Ability

Management ability embodies the management and control over subsidiaries, cost and liquidity control, quality and timeliness of information disclosure as well as effectiveness of operations. A strong management ability can help LIIFCs execute development plan smoothly to achieve their goals, while a weak management ability could disrupt daily operations and bring uncertainties to development prospects.

(3) Financial Performance

The factors of financial performance are based on the LIIFC's financial accounting characteristics. We evaluate their financial management by factors such as capital structure and asset quality, operating efficiency, and liquidity.

(i) Capital Structure and Asset Quality

From the perspective of capital structure, due to the asset injection from local governments to LIIFCs, the scale of capital reserves is relatively large. A huge and growing scale of equity could imply a strong and stable support from shareholder, as well as solid business operation. A larger scale of equity usually means a better score in the credit rating assessment, and vice versa.

From the perspective of debt structure, the total capitalization ratio can help evaluate the debt-serving capability of LIIFCs from the perspective of interest-bearing liabilities. LIIFCs with a low total capitalization ratio usually have a better credit rating as they have advantages in refinancing.

The scale of assets may not fully reflect the future financial performance of LIIFCs given the differentiated quality of assets. Therefore, CCXAP also assesses the asset quality through evaluating the potential return and liquidity of assets. We may assign a better credit rating to the LIIFCs that have a large scale of land resources that locate in vital regions in a city, or a large proportion of assets which can provide a stable cash flow.

(ii) Operating Efficiency

We assess LIIFCs' operating efficiency via operating profit and operating cash inflow to total revenue ratio. LIIFCs usually have a low profitability given their social welfare functions, so they rely on government subsidies. Operating profit evaluates both profitability and subsidies of LIIFCs' businesses, which we believe could fairly reflect their operating efficiency. We would assign a better score to those LIIFCs with a larger operating profit.

LIIFCs may have a time lag between the recognition of revenue and collection of cash. If a LIIFC does not receive cash on time, it may fund its business operation through external financing, which could enlarge its debt burden and weaken its credit profile. Therefore, it is vital to assess the cash collection of LIIFCs. CCXAP uses the ratio of cash inflow from selling goods and providing services to total revenue in the evaluation, with a higher ratio resulting in a better rating.

(iii) Liquidity

The cash to short-term debt ratio and restricted asset to total asset ratio reflect the liquidity positions and refinancing capability of LIIFCs, respectively. The cash to short-term debt ratio shows the capability of LIIFCs to fulfil the short-term debt obligations. A higher ratio reflects a lower liquidity risk and better credit quality, and vice versa.

LIIFCs may pledge their assets in order to raise debt so the proportion of restricted asset to total asset could affect financing capability. In general, LIIFCs with a smaller proportion of restricted asset could be more flexible in obtaining financing, resulting in better credit quality.

(4) Other Considerations

Apart from these rating factors, CCXAP also assesses other aspects, such as proportion of accounts receivable to total asset, external guarantee to net asset, and event risks.

LIIFCs usually deal with the local governments (or other related parties) because of their business nature. Hence, they may record a large proportion of receivables on their balance sheet, reflecting a significant amount of working capital being occupied, which is considered as credit negative. Also, LIIFCs and other state-owned enterprises usually offer guarantees to debts owed to each other. If the guaranteed entities are in liquidity distress, the rated entities may need to repay the debts, resulting in extra cash outflows that weaken their credit quality.

CCXAP will also consider the possibility of unexpected events that could cause sudden and sharp changes in the LIIFCs' overall credit profiles, including asset transfers, mergers and acquisitions, corporate restructures, and lawsuits. These can cause either positive or negative impacts to the credit quality of LIIFCs and we will evaluate the event risks on a case-by-case basis.

2. Extraordinary Support

LIIFCs usually have a relatively weak BCA given their social welfare nature as well as investment and financing functions for local governments, so LIIFCs rely heavily on government support in order to sustain their business operations. In addition, an extraordinary support could help LIIFCs survive when they face financial distress, which is an important consideration for the assessment of LIIFCs' overall credit quality. We consider that both willingness of support and ability to support could affect the extraordinary support received by LIIFCs.

(1) Willingness of Support

In the evaluation of importance of LIIFCs, we focus on the positioning of LIIFCs. Also, by comparing a company's business model with other peers within the same region or under the same shareholder, we can infer the willingness of support from the local government to the company.

(i) Positioning Importance

For the evaluation of positioning importance, CCXAP assesses the involvement of LIIFCs in land development, infrastructure construction and urban operation. Also, we consider whether LIIFCs engage in the operation of state-owned assets and resolution of local debt issues. If a LIIFC deeply engages in these businesses, the company's operational performance will be closely related to the development of the city, and the local government will be more willing to provide support to the company since its default would cause a significant adverse effect to the city.

(ii) Regional Importance

Another factor that affects the local governments' willingness to provide support is the regional importance of LIIFCs. If a LIIFC is the sole investment and financing company in the region, the local government would be more willing to provide support given its unique strategic importance. But if a LIIFC has a very small scale of asset and does not have a clear role as compared to its peers within the region, we expect that the local government would be less willing to provide support.

(2) Ability to Support

For the ability to support the LIIFCs, CCXAP evaluates utilizable resources as well as the resource allocation of the local governments.

(i) Resource Utilization

In the evaluation of utilizable resources, the local government with better credit profile implies that it has a stronger capability to support the LIIFCs, in terms of asset injections or subsidies. Also, the local governments that have a relatively large amount of on- and off-balance sheet resources have more utilizable resources, which could be allocated to improve the liquidity of LIIFCs.

(ii) Resource Allocation

The resource allocation capability of local governments is a key determinant of their ability to support LIIFCs. By coordinating with local financial institutions, LIIFCs can have a lower financing cost and improve their liquidity by receiving funds from the financial institutions, which can reduce the default probability of LIIFCs.

Assumptions and Limitations

The final ratings assigned are based on CCXAP's forward-looking opinions, that we assume any changes of the macro environment are aligned with our expectations, and do not incorporate any unanticipated changes, such as outbreak of war and destructive natural disaster.

CCXAP assumes that there is a strong correlation between the sovereign credit risk and the rated entity, while refinancing capability is the key driver of credit risk. The debt rating assigned is based on our view that legal priority of claim is the key factor affecting the ratings for different classes of debt issued by the same issuer. Also, we assume that the data used in the rating is true, legal and does not incorporate misleading statements.

The ratings incorporate our expectations of the rated entity's future performance, which are mainly deduced from the historical information via our forward-looking model. Under some circumstances, the expectations would incorporate confidential information. In addition, our expectations would consider the industrial trend, rival analysis, and other considerations. In any case, predication is subject to substantial uncertainty. Therefore, the mapped ratings may not match our final ratings. The ratings may include some qualitative factors. CCXAP would evaluate these factors in an objective and precise approach, but the assessment may be unavoidably affected by subjective view on some occasions. Therefore, the weighting of rating considerations could be varied. Specifically, the variation in weighting would happen if the rated entity is in default or approaching to be in default.

Also, the ratings rely on the public information and information provided by the rated entity and underwriters. Despite that CCXAP would ensure the integrity, truthiness and completeness of the data, the ratings, on some occasions, may not timely reflect the rated entity's credit risk due to the delay of information.

Apart from that, the ratings are decided by our rating committee and could be influenced by their empirical views which may not be incorporated in the rating methodology. As a result, the final ratings could be varied with the mapped rating from the methodology.

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