Rating Methodology

28 June 2022

Request for Comments: China's Local Infrastructure Investment and Financing Companies

Industry-specific rating methodology

CCXAP publishes Request for Comment (RFC) on the update of methodology for China's Local Infrastructure Investment and Financing Companies

Summary

This proposed rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") applies to China's local infrastructure investment and financing companies ("LIIFCs"). A LIIFC should engage in public or quasi-public projects, or non-operating business, or investments in projects that can provide strong social effects, which are featured by high reliance on subsidy or government support.

The credit rating of a LIIFC is determined by (1) RLGs' capacity to support, and (2) LIIFC's characteristics affecting RLG's willingness to support. RLG's capacity to support is primarily considered in our internal credit rating assessment under the methodology of Regional and Local Governments. For RLG's willingness of support, we primarily evaluate a LIIFC's business and operational profile, financial risk and control, and negative government intervention or potentials for additional government support. Other factors are also included to consider the variance among different LIIFCs.

This proposed rating methodology replaces the "Rating Methodology for China's Local Infrastructure Investment and Financing Companies" published by CCXAP in May 2020. The proposed update revises the rating framework to a top-down approach in assessing the credit quality of China's LIIFCs and removes the baseline credit assessment on LIIFCs combined with extraordinary support from RLGs.

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Impact on Ratings

The update of rating methodology is expected to result in a small number of rating changes for some rated entities that are applied to the scope of this rating methodology.

How to Submit Comments

In this request for comment, CCXAP invites interested market participants to submit written comments on the proposed rating methodology by 27 July 2022 on the Request for Comment page or via email at info@ccxap.com. CCXAP will review and take all received comments into account before publishing the methodology.

Introduction of Rating Methodology

RLGs typically undertake infrastructure projects that are not self-supporting and may not generate meaningful economic returns. As such, these projects may rely on RLGs' financial support, such as subsidies, grants or repurchase or procurement fees. We consider a LIIFC should have the majority of assets related to public policy projects and have very close operational and financial ties with RLGs.

CCXAP's overall framework for assessing LIIFC's rating has two main components: (1) the capacity of government to provide support; (2) the willingness of government to provide support, which is based on the LIIFC's business position, operational profile, financial risks, and debt controls. We use a top-down analytical approach and determine the LIIFC's rating by notching based on RLG's capacity to provide support. The notching consideration involves several factors, including qualitative and quantitative determinants. Notching for different factors could be downward or upward in our rating framework, and most of the cases would be downward adjustments. The rating methodology provides a summary of the guidelines that contains 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.

Key Rating Determinants

1. Government's Capacity to Provide Support

The government's capacity to provide support is vital to our analysis of LIIFCs. It is largely determined by our internal assessment of the direct RLG owners or controllers or relevant entities that are most likely to provide support should a LIIFC faces liquidity issues. Our internal assessment of RLGs is based on the methodology of Regional and Local Governments, which include assessment of idiosyncratic risks (such as economic strength, financial performance and debt profile), systemic risks and extraordinary support. The government's capacity to provide support to RLGs is capped by China's sovereign rating, which is typically lowered by the administrative distance between the central government and the RLG, as well as the RLG's economic and fiscal fundamentals.

The following are the key factors for determining the government's capacity to provide support**.**

(1) Idiosyncratic Risk

This is assessed by looking at a RLG's fundamentals, including economic strength (GRP, real GRP growth, GRP per capital, etc.), financial performance (total revenue, total revenue growth, taxes/operating revenue, operating revenue/operating expenditure), debt profile (debt/GRP, debt/total revenue, interest payment/operating revenue), and institutional framework, governance, and management. They consist of both qualitative and quantitative considerations and also some adjustment factors.

(2) Systemic Risk

The creditworthiness of its higher-tier government is often viewed as an indicator of the systemic risk faced by the rated RLG. The credit quality of a RLG may be intricately linked to the credit risk of its high-tier government, given the high correlation between their economic and financial conditions.

(3) Other Considerations

These include the adjustment factors for evaluating baseline credit assessment, such as the degree of local economic diversification, existing debt structure and liquidity management practices, indirect and hidden debts (including debts guaranteed by the RLG or issued by state-owned enterprises), and ESG assessment.

(4) Extraordinary Support

Our assessment considers the likelihood of extraordinary support from higher-tier government in the case of acute liquidity stress, which would help increase a RLG's credit level and lower the probability of default on its obligations. Extraordinary support from higher-tier government means that when the rated government faces severe debt servicing pressure, its higher-tier government would provide support to repay its debt or take actions to avoid its debt default. The evaluation covers economic and politically important factors, legal requirements and degrees of oversight, as well as support strength and willingness of the higher-tier governments.

2. Government's Willingness to Provide Support

The willingness of government to provide support is based on our objective observations and subjective judgements. We believe a LIIFC's own characteristics will influence the likelihood of support from the owner RLG or controller, as a LIIFC's business activities and financials are highly directed and supervised by them to meet its mandate and strategic mission in local infrastructure projects and public services, which often do not provide meaningful returns. To determine the willingness of government to provide support to a LIIFC, we evaluate its (1) business and operational profile, (2) financial risks and controls, (3) negative government intervention and potential for additional government support.

(1) Business and Operational Profile

The business and the operational profile of a LIIFC are key indicators that influence the likelihood and timeliness of support from the government. The RLG is likely to prioritize its supporting resources to local state-owned enterprises of relatively high importance. Given their public roles and mandates, LIIFCs generally have higher importance than other local state-owned enterprises. The failure of LIIFCs could carry higher reputational risks and, given the nature of their businesses, finding substitute entities to fill their roles would not be easy. If a LIIFC conducts business that deviates from the public mandate, such as expanding commercial activities, it will be detrimental to the willingness of government to provide support, and it will be less important to its owner RLG or controller. CCXAP assesses a LIIFC's business and operational profile based on the importance and sustainability of its primary public activities and the risks of its commercial activities.

(i) Business Position

When evaluating a LIIFC's business position, we consider the relative importance comparing to local peers that are owned by the owner RLG and the ability of other entities to take up its public mandate in case of the failure of the LIIFC. We typically consider a LIIFC to have a higher business position if it assumes most of local public activities, owns majority of assets of local public projects, possesses strong expertise in performing public activities or absence of other entities with similar functions. Potential for substitution to be low in the region and priority to be supported is very likely. Failure of a sole strong position of LIIFC will significantly increase a RLG's reputational risk and cause disruption to local public services. Conversely, a LIIFC that is considered to have lower business position and higher risk of substitution if there are many peers with similar functions or the scale of its activities is small for its owner RLG. Failure of such a LIIFC would be more manageable for RLG and have relatively low long-term impact on RLG's reputation and disruption in the region.

(ii) Importance of Primary Public Activities

The nature of public activities is important for LIIFCs because the local government will typically prioritize their resources to entities that undertake more important projects or have higher national or regional policy goals. We will compare the relative importance of a LIIFC's public activities with its local peers. Activities that are essential to the local economy and provide benefits to the majority of the public are deemed to be more important. In addition, if the activities have strong national governmental policies and long-term strategic significance to the higher-tier government, it will be scored higher in this sub-factor. For example, it is credit positive for essential activities such as public projects in major metropolitan areas and national new district, critical infrastructure projects such as national or regional important transportation or logistic networks, and fundamental social services. Non-essential activities, even if projects are suspended, do not have a great impact on the daily lives of most people or the key goals of the RLGs. These goals include land development or property projects with larger commercial elements, as well as culture and tourism projects. The importance of public activities is dynamitic and is subject to changes in government policy.

(iii) Stability of Primary Public Activities

Stability of a LIIFC's public activities is important to maintain its business position. We will assess LIIFC's historical changes in public activities and existing project reserves. Higher stability of public projects and larger project reserves will be positive to this sub-factor, allowing for greater visibility and predictability of its business position. Indicators may include historical project executions, existing public project tenors, and scale of project reserves to meet its future development. A LIIFC with unstable project execution records, short-term project bases, or very small scale of project reserves tend to be scored lower due to the high degree of certainty over its future operational profile. Frequent transfer-out of public projects may increase our concern over its importance.

(iv) Risk of Commercial Activities

Commercial activities are different from LIIFC's public activities. It is more difficult for a RLG to use its own fiscal resources to support LIIFC's commercial activities. Regulatory trends in China also seeks to separate LIIFCs' debt obligations from the RLGs and strictly limits the RLGs' use of fiscal budgetary funds. A large increase in the exposure to commercial activities generally indicates a less important policy project and is likely to decrease the likelihood of support. We generally assess the risks of LIIFC's commercial activities by looking into the project scale relative to its overall business profile and the inherent risks of these activities. The total scale of commercial activities for a LIIFC is accounted by its debt, capitals or assets that are specifically related to these activities over the total. Moreover, we will evaluate the level of risk inherent in its commercial activities. Commercial activities that are self-sustaining or is likely to be backstopped by RLG's financial resources are generally less risky. Commercial activities that are expected to cost LIIFC significant financial resources or have greater levels of intensive competition, market uncertainty and cyclicality are much riskier in general. For example, a market-competitive commercial real estate business is riskier than a property lease on a government building, which is likely backstopped by RLG's financial resources.

(2) Financial Risk and Control

LIIFC's financial profile largely reflects the direction, supervision, and control of RLG or its controller, so it can take on a higher leverage than other private companies because of the expectation of government support. Nevertheless, the willingness of support provided to LIIFCs will vary according to their own financial profiles. LIIFCs with weak debt management or high potential for financial problems are less likely to receive timely support. Therefore, we will assess the financial risks and controls of LIIFCs. Considerations include debt management and asset liquidity, access to capital, predictability and enforceability of government payments, and exposure to contingent risks.

(i) Debt Management and Asset Liquidity

Maintaining effective debt management and a good asset base are critical for a LIIFC to maintain the confidence of its lender so as to secure the necessary funding for its substantial investment needs and to discharge its public mandates. We typically assess a LIIFC's debt management capability and its asset liquidity. Instead of focusing on the absolute amount of debt level or the debt leverage of the LIIFC, we consider its debt growth, the reasons behind the debt growth, and its debt repayment plan. It will normally be notched higher if a LIIFC has strong debt management capabilities, such as prudent debt growth that is not materially higher than local economic growth, new debt growth mainly from medium-term infrastructure investment needs, medium-term public projects that are of high importance to the central or regional government, and established plan to meet its future capital needs. A LIIFC with good asset liquidity will also benefit its debt repayment ability and increase its financial flexibility. We believe that if a LIIFC has a large number of quality land assets, such as those located in major urban areas, or assets that can generate stable cash flows, confidence of its lenders will be enhanced.

(ii) Access to Capital

CCXAP assesses a LIIFC's access to capital as one of the key indicators of its financial risks and controls. We typically evaluate the quality and diversity of its funding channels. In general, we assign better scores to LIIFCs with strong banking relationships and robust access to low-cost funding. For example, a LIIFC's primary funding sources that are composed of lending from competitively priced and diversified loans provided by large Chinese policy banks or commercial banks, or debt issued in the Chinese public bond market, with good refinancing track record, will receive a better notching. The proportion of non-standard financing such as trust, wealth management products, financial leasing lending should be low, because they tend to bear higher financing costs, and are relatively unstable for refinancing during stressed financial market or when there is high risk related to policy changes. A LIIFC with large non-standard financing and limited credit facilities provided by a few small to medium banks will score lower.

(iii) Predictability and Enforceability of Government Payment

Government payment is the key source of cash flow for a LIIFC to finance its operations and service debt. It is also a good indicator to reflect the willingness of its owner RLG or controller to provide support. Government payments can take many forms and can vary from government to government. It includes financial subsidies, capital injections through project buy-backs, procurement fees, rebates, etc. The RLG will generally enter into an agreement with the LIIFC to provide public services or construct local infrastructure. However, the timing and amount of these government payments are often subject to the strong discretion of RLGs. Therefore, we mainly study the enforceability and predictability of these different forms of government payments, including the payment mechanisms, past execution of such mechanisms, and sources of repayment from the government. If a LIIFC has clear contractual arrangements with a proven track record of timely, sufficient and recurring government payments, it may indicate a higher level of government support and thus a better score.

(iv) Exposure to Contingent Risks

LIIFCs generally assume contingent risks in relation to the provision of loans or guarantees to third parties, which are mainly mandated by RLGs for various reasons. These loans or guarantees could negatively impact LIIFCs' credit quality, as defaults on the loans or calls on the guarantees will create additional funding needs for the provision of liquidity help and impair its equity base. Cash outlays can also adversely affect LIIFC's temporary access to funds from financial institutions, and it is often unclear how the RLG will compensate for its losses. The LIIFC may be exposed to higher counterparty risks if it provides loans or guarantees to weak private enterprises. We will evaluate the LIIFCs aggregate credit risk exposure, including loans, guarantees and other similar offerings.

(3) Negative Government Intervention or Potentials for Additional Government Support

CCXAP will also consider potential government intervention risks and potential additional government support. Given the high level of control over LIIFCs, the RLG may use a LIIFC's financial resources to support other local SOEs or private companies, creating credit drags on the LIIFC. For instance, the RLG may require a financially stronger LIIFC to participate in local M&A transactions to help weak entities. Such actions may indicate a low willingness of support if the RLG does not adequately compensate the LIIFC. We typically consider the government's track record in directing the resources of the LIIFC to support other entities, the likelihood of such an occurrence and the potential impact on its financial profile. The high possibility of providing material support from the LIIFC may result in a downward adjustment to its rating. We usually do not have downward notching if the potential financial impact or likelihood is considered to be limited or small.

Meanwhile, in some limited cases, CCXAP may consider a LIIFC to receive higher support than other local LIIFCs because of its importance to the higher-tier government. The stronger support expectation is usually accompanied by the presence of extremely strong government payment mechanisms, such as designated use of RLG bond proceeds, direct transfers or fiscal budget allocations from higher-tier government. This sub-factor can result in an upward adjustment.

3. Other Considerations

CCXAP may consider other factors that are not included in the above rating factors, as the credit importance of these factors varies widely among different LIIFCs. Additional considerations include regulatory considerations, corporate governance and controls, track record of support, liquidity, and event risks, which may result in downward or in some rare cases, upward notching. As a result, the ultimate rating may differ from the indicated rating.

(1) Regulatory Considerations

LIIFCs are subject to evolving regulations in China. The impact of these regulations may limit operations or funding sources, thereby lowering our judgment on the willingness of the government to provide support. In some circumstances, regulatory changes or regulatory uncertainties may affect ratings.

(2) Corporate Governance and Control

Corporate governance and control are important factors underpinning a LIIFC's credit strength. The management's strategy formulation, development plans and governance concepts help us predict and evaluate the performance of the management.

(3) Track Record of Support

A history of the absence or delay in timely government support for distressed LIIFCs or other public or non-entities can signal systemic constraints on support capacity or a low willingness to provide support to failing entities, independent of the specific characteristics of the LIIFCs.

(4) Liquidity

If the local government's financial support for a LIIFC's is unpredictable, the LIIFC's liquidity will be an important consideration. CCXAP assesses the liquidity of a LIIFC's through the ratio monetary funds to the short-term debt. The ratio reflects its ability to repay its short-term debt, while a higher ratio represents lower liquidity risk and stronger credit quality.

(5) Event Risk

We also recognize the possibility that an unexpected event could cause a sudden and sharp decline in a LIIFC's fundamental creditworthiness, which could result in the actual rating being lower than those indicated on the scorecard. Unexpected events can include M&A, asset sales, spin-offs, litigation, pandemics, and significant cyber-crime events. Such events can overwhelm even a stable and financially sound LIIFC.

(6) ESG Assessment

ESG assessment mainly evaluates the impact of credit risk-related environmental, social and governance factors on the credit strength of LIIFCs. The impact of ESG assessment on a LIIFC's credit risk is often negative, such as social instability caused by serious social security problems, deterioration of the living environment due to environmental pollution, and reduced governance capacity due to sudden security incidents.

Assumptions and Limitations

The final ratings assigned are based on CCXAP's forward-looking opinions, which 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 claims 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 in some cases. Therefore, the weighting of rating considerations could be varied. Specifically, the variation in weighting would happen if the rated entity were in default or approaching to be in default.

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

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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