Interim Report

July 22, 2019

CCXI

Local Government Bonds and Financing Vehicles

LGFV Financing improved with Recovered Bond Issuance and the Dual Task of Stabilizing Growth and Preventing Risks Poses Both Opportunities and Challenges

- Review and Outlook of LGFV Industry of the First Half of 2019: Market Performance

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Main Opinions

✧ **Market performance: Issues picked up significantly, financing improved and LGFVs showed continued divergence.**

➢ **Outstanding bonds: AAA-rated accounted for a larger percentage of outstanding LGFV bonds, corporate bonds taking up a shrinking share.**

➢ **Primary market: the scale rebounded, interest rates turned down with fluctuations and the low- and medium-rating bonds and debt refinance bonds took up bigger shares.**

LGFV bond issues recovered throughout 1H2019. LGFV bond issues surged year-on-year (YoY) to hit RMB1587.36 billion. AAA bonds represented the majority, but taking up a smaller proportion. The share of low- and medium-rated bonds and bonds issued to refinance preexisting debts picked up, and the proportion of privately placed bonds rose quickly. Issue interest rates trended downwards amid fluctuations, showing further structural divergence.

➢ **Secondary market: transactions recovered markedly, yields subdued and credit spreads were obviously divergent.**

The overall liquidity was reasonably easy in H1, the money market saw a decline in interest rates and the LFGV bond market sentiment improved remarkably. Spot bond transactions totaled RMB3984.565 million, representing a sharp YoY or MoM rebound. Yields varied much with maturities, short-term yields falling substantially. The credit spread for AA- rating showed the largest contraction from the end of last year. Hainan Province recorded the highest credit spread of LGFV bonds.

✧ **Credit rating: All LGFVs saw their ratings upgraded, with non-standard debt defaults increasing by about two times YoY.**

➢ **Credit incidents:** Non-standard debt defaults at lower administrative levels remained serious and defaults on trust products increased significantly. 17 LGFVs were involved in non-standard debt defaults.

➢ **Rating adjustments:** No downgrades occurred in H1. The upgrades were mainly attributable to regional economic development, increased government support and improved operating capability.

➢ **Early redemption:** The scale of early redemption shrank YoY. The share of medium- and high-rating bonds rebounded.

✧ **Maturity status: The average monthly size of bonds to mature between July and December exceeds RMB100 billion, posing a still-large debt rollover pressure.**

➢ **The maturity and sell-back pressure is still high, and the issuer ratings of maturing bonds are still mainly medium to high.** In H2, the maturity and sell-back pressure is particularly high in September. The issuer ratings for bonds to mature and sell back are dominated by AAA grade, and their proportion picks up somewhat.

➢ **Jiangsu Province still has the largest scale of maturing bonds. The proportion of bonds with special terms and conditions continue to expand.** The bonds with special terms and conditions account 50.27%, up about 2 percentage points over the end of last year.

➢ **More than 60% of the issuers involved in maturing or sell-back show insufficient operating cash flows to cover interest-bearing debts.** Issuers are under an obviously higher pressure of serving debts with own operating cash flows than at the end of last year, and their dependence on refinancing and realization of current assets has increased.

✧ **Outlook: Opportunities and risks coexist. Due attention should be paid to structural opportunities in the context of LGFVs' mixed performance**

In H1, the money market maintained reasonably ample liquidity, saw interest rates falling. **The primary and secondary markets of LGFV bonds recovered markedly.** However, LGFV bonds are subject to market-oriented transformation requirements and show **rising structural divergence**. LGFVs that undertake major projects in key fields and weaker sectors will receive more support. **In H2, LGFVs will still face a heavy debt service pressure.** Against the backdrop of increasing downward pressure on the economy, forestalling risks will remain the focus of the LGFV regulatory policies. Focus should be placed on the following aspects in the forthcoming stage:

1） Pay attention to the positive effects of the new rules for special bonds on the financing environment of LGFVs.

2） Pay due attention to the positive effects of hidden debt reduction and market-oriented transformation of LGFVs

3） Look for opportunities for LGFVs in the renovation of aging residential communities

4） Pay due attention to non-standard debts and contingent debts of LGFVs to prevent risk resonance

5） Pay due attention to the credit risk of LGFVs in financially weaker areas amid the higher downside pressure to the macro-economy

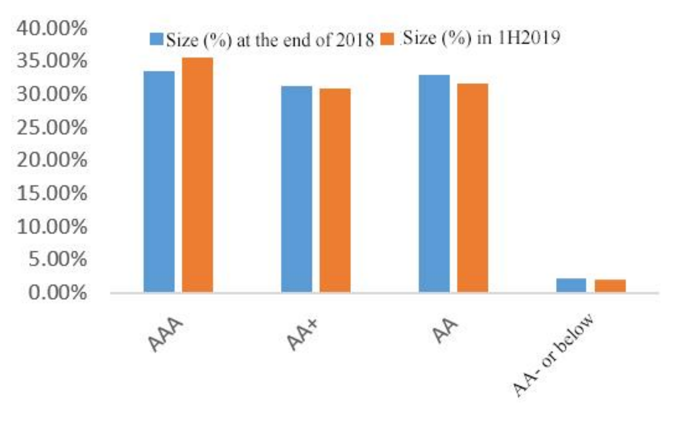
In first half of 2019, the monetary policy remained structurally easy and the financing environment for the LGFV (Local Government Financing Vehicles) industry improved as the macro regulation aimed at striking a dynamic balance between stable growth and risk prevention. On the one hand, the policy environment of the LGFV industry improved marginally under the stable growth requirements, encouraging LGFVs to precisely focus on key fields and major projects, and the issuance and trading of LGFV bonds improved significantly over one year earlier. On the other hand, the risk prevention requirements were still stringent strict. The regulatory authorities continued to urge hidden debts to be reduced. The market-oriented reform of LGFVs continues, and LGFVs will be further divergent. In addition, the number of defaults on non-standard LGFV debts rose YoY. LGFVs will remain under the maturing and sell-back pressure in H2. This paper reviews the performance of the LGFV industry in 1H2019, and looks forward to the opportunities and risks of the LGFV industry in H2 in combination with the policy trends and maturity status of LGFV bonds.

I. Market performance: Issues picked up significantly, financing improved and LGFVs showed continued divergence

i. Outstanding bonds: AAA-rated accounted for a larger percentage of outstanding LGFV bonds, corporate bonds taking up a shrinking share

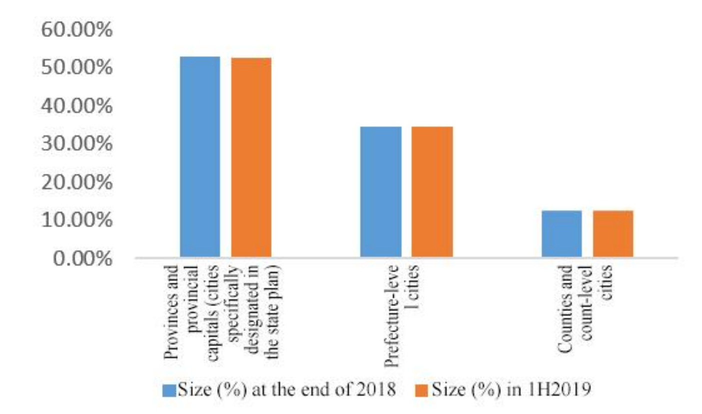
At the end of June 2019, there were 9,375 outstanding LGFV bonds totaling RMB8,259,128 million, up 6.93% over RMB7,723,888 million as at the end of 2018. **By issuer rating,** the proportion of LGFV bonds issued by AAA-rated entities reached 35.53%, up about 2 percentage points compared with the end of 2018. The proportion of those from AA or lower-rating issuers decreased by about 1.5 percentage points. **By administrative level,** provincial LGFV bonds accounted for the largest percentage, while the share of municipal LGFV bonds increased slightly. **By bond type,** all types of LGFV bonds except enterprise bonds and PPNs took up a larger share of total issue size than that at the end of last year.

Fig.1: AAA-rated Issuers Had a Markedly Bigger Size of Outstanding Bonds



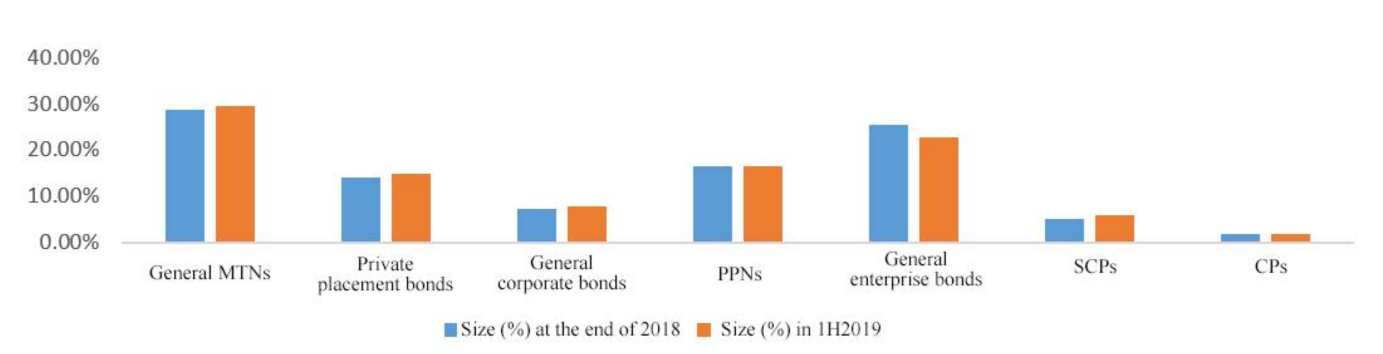
Source: choice, CCXI International Macro Interest Rates

Fig.2: The Proportion of Municipal-level LGFVs Rose Slightly.



Source: choice, CCXI LGFV Industry Database

Fig.3: Enterprise Bonds and PPNs Took Up a Smaller Share, While the Proportions of All Other Bonds Picked up

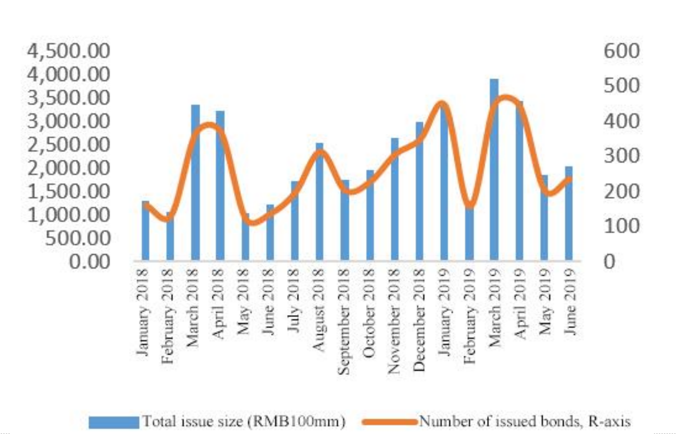


Source: choice, CCXI International Macro Interest Rates Database

ii. Primary market: the scale rebounded, interest rates turned down with fluctuations and the low- and medium-rating bonds and debt refinance bonds took up bigger shares

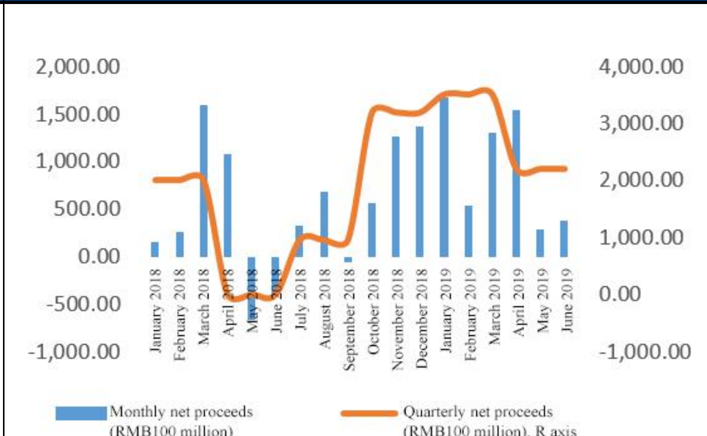
The issue size of LGFV bonds rose sharply in 1H2019, with 1,928 bonds totaling RMB1587.36 billion issued, up 41.80% YoY. **In terms of trends in bond issues, the issue size fluctuated greatly,** including RMB853.478 billion for Q1. Except February, the monthly issue size was higher than that for the same period last year. In H2, bond issues amounted to RMB733.882 billion. The issue size was large in April and fell in May before a slight pickup in June. Each month in Q2 saw a YoY increase in issue size. **By net proceeds,** net proceeds reached RMB572.873 billion, a slight decline in H1, but the size more than doubled over the same period last year.

Fig.4: Issue Size of LGFV Bonds Expanded Significantly over One Year Earlier



Source: choice, CCXI International Macro Interest Rates

Fig.5: Net Proceeds Remains Positive, Falling in Q2 from Q1

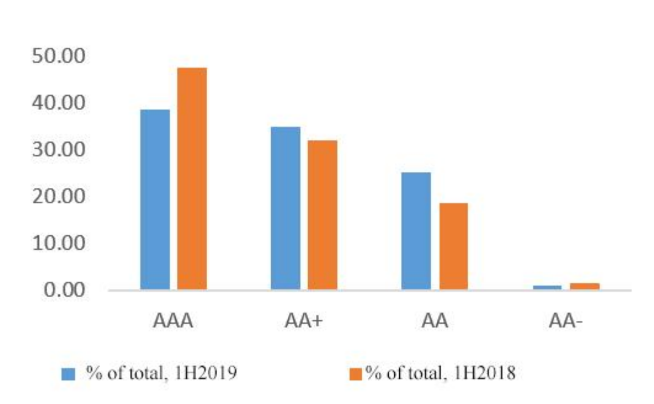


Source: choice, CCXI LGFV Industry Database

1. The low- and medium-rating bonds and debt refinance bonds took up bigger shares, the proportion of private placement bonds surging

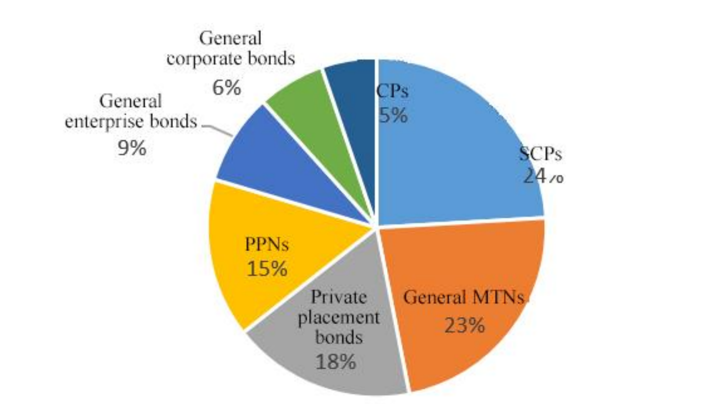
By credit rating of bond issuer, the LGFV bonds were issued mainly by AAA-rated issuers in H1, accounting for 38.68%, yet down 8 percentage points YoY. The proportion of the AA rating recorded the fastest growth, up nearly 7 percentage points to 25.21% YoY. By bond type, the proportion of SCPs was still the highest, reaching 24.08%, yet down about 7 percentage points YoY. However, the proportion of corporate bonds, including private placement bonds, reached 23.92% in H1, second only to SCPs, with a YoY pickup of about 9 percentage points. **By way of issuance,** private placement bond issues as a percentage of total issue value increased significantly YoY, from 7.70% in 1H2018 to 17.50% in 1H2019, more than doubling over one year earlier. **By purpose of proceeds,** as the exchanges' window guidance relaxed the restrictions on refinance bonds by selected LGFVs in March, 67.94% of the bonds with their purposes disclosed were used to refinance old debts, up 4.48 percentage points YoY, showing increasingly stronger recovery. **By term of bond,** the newly issued LGFV bonds will mature mainly in 1 to 5 years, accounting for 59.77%, a sharp rebound of about 20 percentage points YoY. **By geography,** Jiangsu Province still ranked first in the country in terms of issue size, recording an issue size of RMB348.064 billion, up 48.03% YoY, accounting for 21.95% of national total, followed by Zhejiang and Sichuan. Qinghai had the fastest growth rate of 300% despite its small issue size

Fig.6: Share of AA-rated LGFV Bond Issues Grew Fast



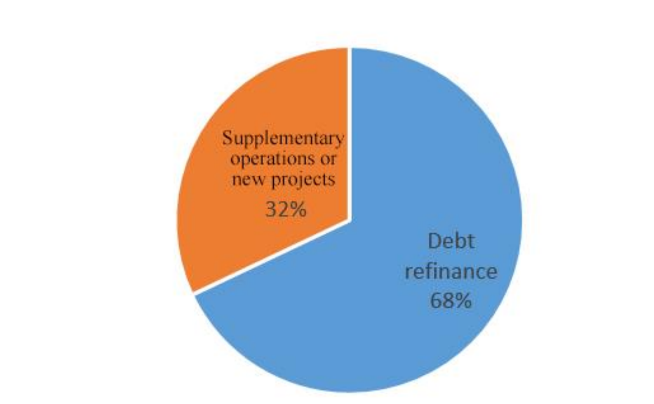
Source: choice, CCXI LGFV Industry Database

Fig. 7: New LGFV Bond Issues Were Mainly SCPs, with the Proportion of Corporate Bonds [1]Growing Fastest



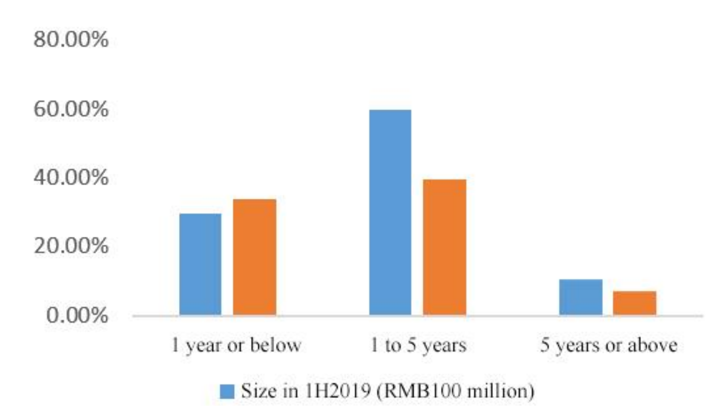
Source: choice, CCXI LGFV Industry Database

Fig.8: Nearly 70% of New LGFV Bonds Are for Debt Refinance Purposes



Source: choice, CCXI LGFV Industry Database

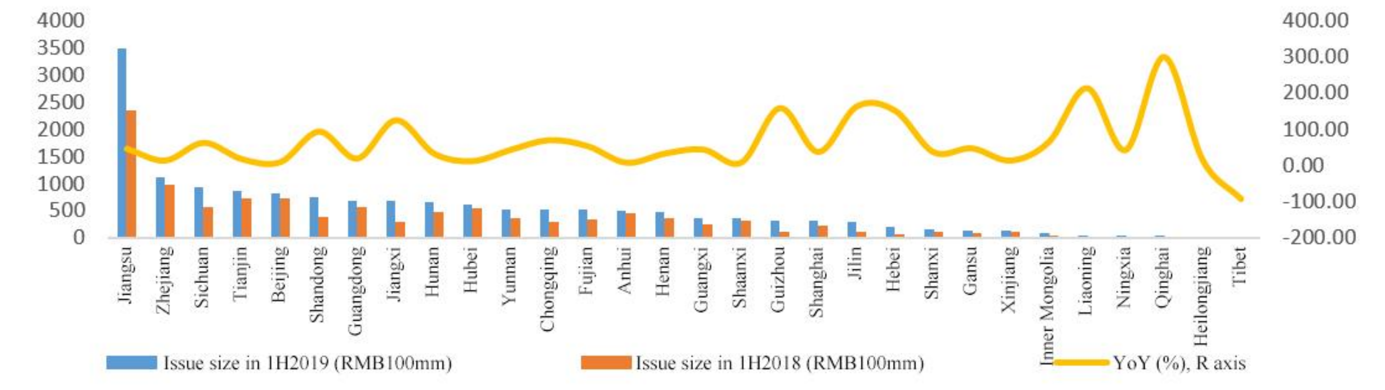
Fig.9: New LGFV Bonds Principally Have a Term of 1 to 5 Years



Source: choice, CCXI LGFV Industry Database

Fig.10: Jiangsu Had the Largest Issue Size, Followed by Zhejiang and Sichuan, Qinghai Recording the Fastest YoY Growth

1 Including general corporate bonds and private placement bonds.

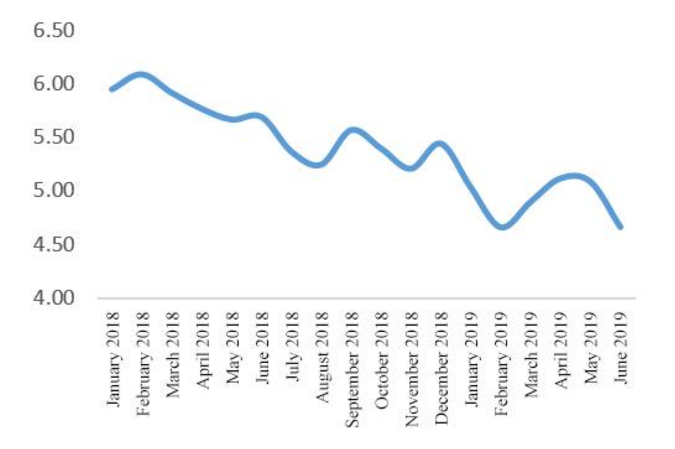


Source: choice, CCXI LGFV Industry Database

2. The issue cost fluctuated in a downward trend, showing a large drop among bonds with higher ratings and higher administrative levels.

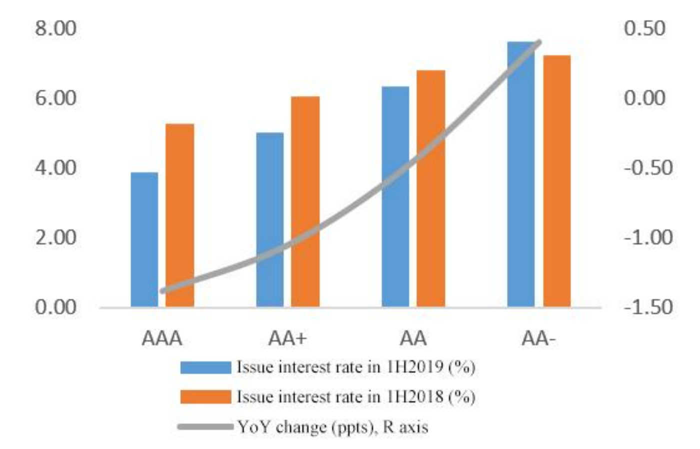
By overall trend of the issue cost, the issue interest rate of LGFV bonds fluctuated in a downward trend due to the reasonable sufficient market liquidity and continued structurally looseness of monetary policy in H1. March and April saw a pickup in issue interest rates of LGFVs due to the tightening benchmark rates. **By credit rating,** the trends in issue costs varied significantly with credit rating. The issue costs for AA or higher-rating LGFV bonds fell significantly from 1H2018. The AAA rating witnessed the sharpest decline, with the weighted average issue ate falling by more than 1 percentage point, while the issue cost of LGFV bonds rated AA- rising by 0.40 percentage point YoY. **By bond type,** the issue costs declined for all types of bonds, of which CP, SCPs and general corporate bonds were among the top three with a YoY drop of more than 1 percentage point. Enterprises bonds saw the weakest decline, albeit the highest absolute level, of issue costs, with a weighted average issue ate of 6.41%. **By administrative level of LGFV issuer**, the issue costs declined for LGFV issuers at all administrative levels. Provincial LGFV issuers saw the sharpest YoY drop by 1.16 percentage points to a weighted average issue rate of merely 4.38%.

Fig.11: Issue Costs Remained Volatile in a Downward Trend

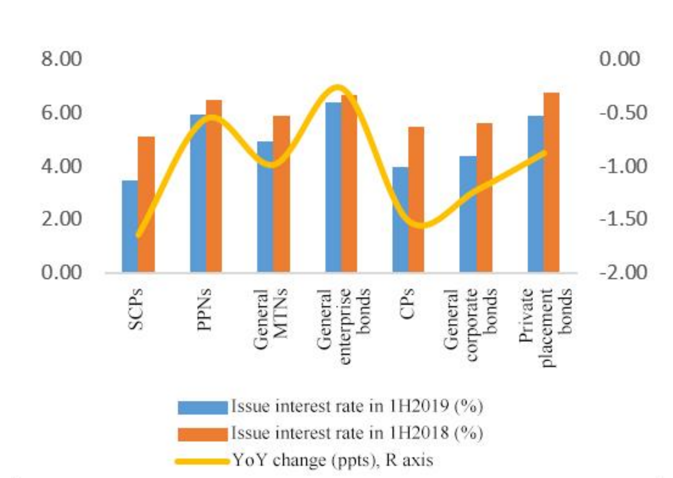
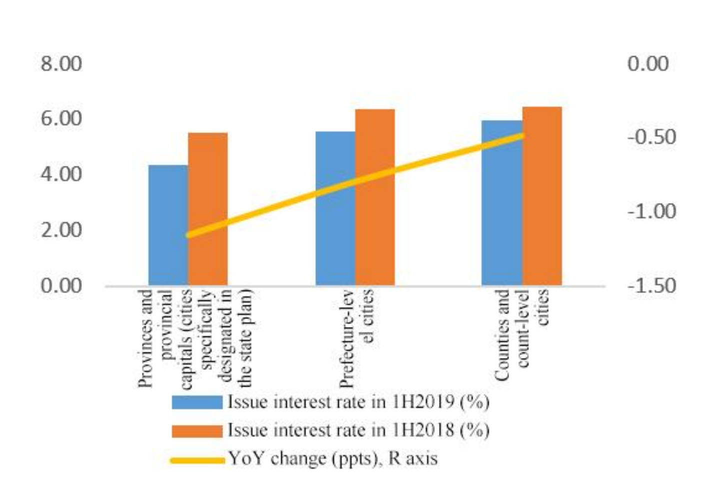


Source: choice, CCXI LGFV Industry Database

Fig.12: Issue Costs Fell for All Credit Ratings, Except AA-

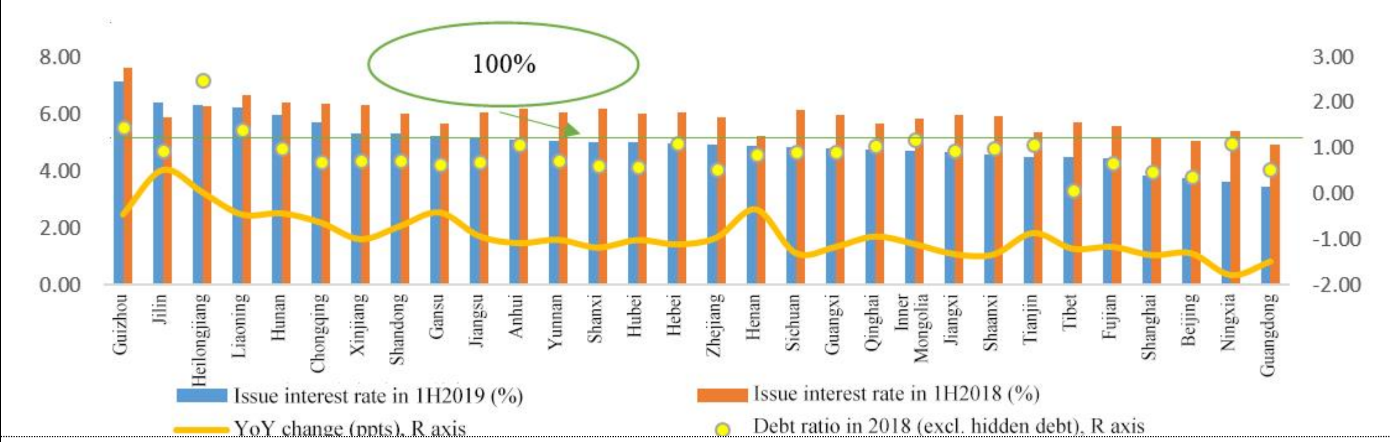


Source: choice, CCXI LGFV Industry Database

Fig. 13: Issue Cost Dropped for All Types of Bonds	Fig.14: Provincial LGFVs Still Recorded the Sharpest Fall in Issue Costs
	
Source: choice, CCXI LGFV Industry Database	*Source: choice, CCXI LGFV Industry Database*

By geography, the issue costs of LGFV bonds were higher in Guizhou, Jilin, Heilongjiang and Liaoning in 1H2019, where the local governments' debt ratios[2] were also high in 2018, which all (except that of Jilin) exceeded the international warning line of 100%; in particular, that ratio hit 250% in Heilongjiang. **By changes in issue costs,** all provinces registered a retreat in issue costs except Jilin and Heilongjiang, which saw their issue costs rising by 0.52 and 0.04 percentage point YoY respectively. The rising issue costs in Northeast China may aggravate the debt rollover pressure in the region.

Fig. 15: Issue Costs of LGFV Bonds Dropped Overall, Showing Marked Regional Divergence



Source: choice, CCXI Regional Risk Database and CCXI City Infrastructure Industry Database

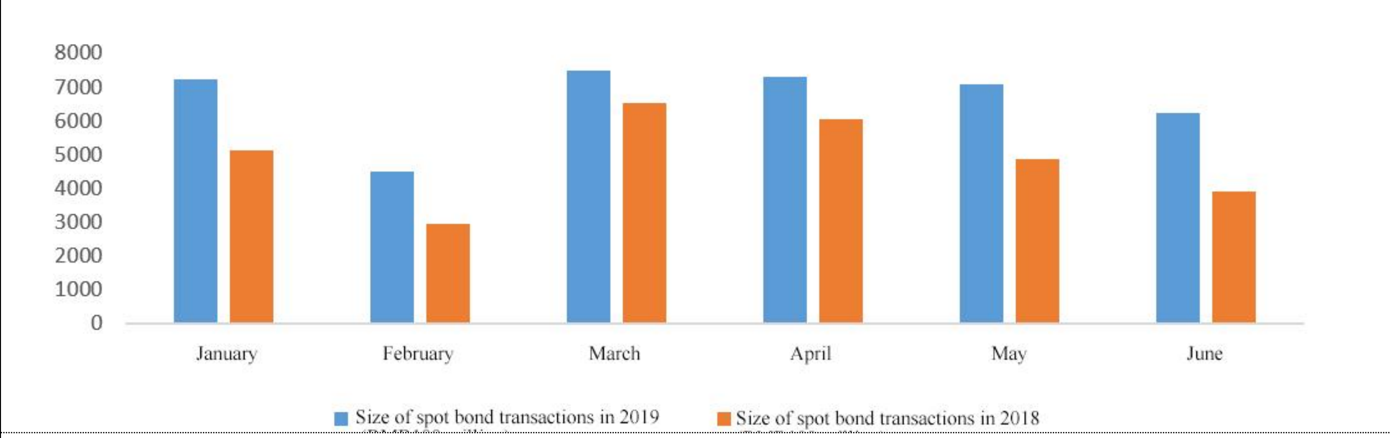
iii. Secondary market: LGFV bond transactions recovered markedly, yields subdued and credit spreads were obviously divergent.

1. The trading volume of spot bonds increased significantly YoY, with yields remaining divergent across different terms

[2] Excluding implicit debt

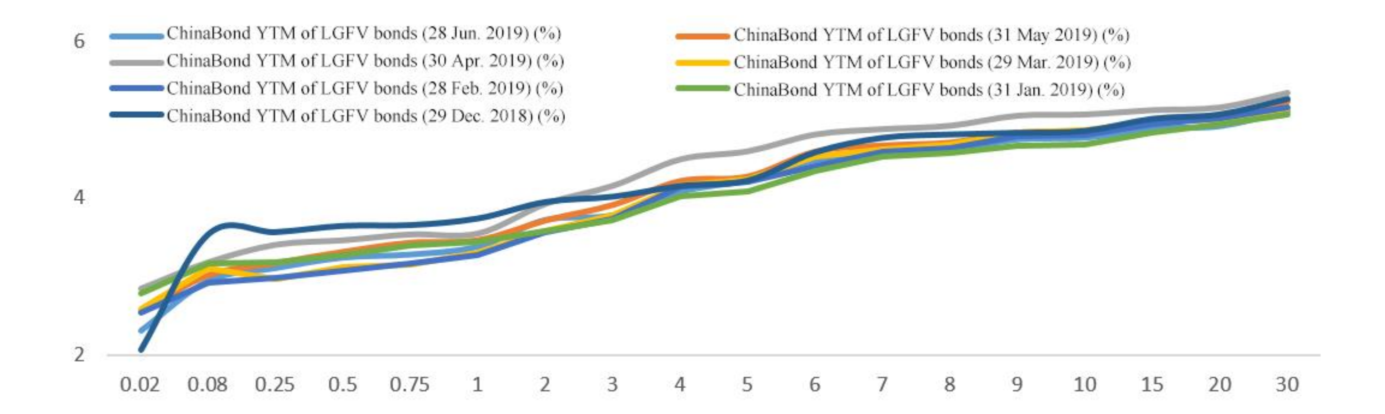
The overall liquidity was reasonably easy in H1, the money market saw a decline in interest rates and the LFGV bond market sentiment improved remarkably. Spot transactions on LGFV bonds reached RMB3,984,565 million, up 35.22% YoY and 14.52% MoM, accounting for nearly 40% of the trading volume in the secondary market of credit bonds and relatively stable. **By credit rating,** trading focused on medium and high ratings, with AA+ and higher ratings accounting for 75.25% of the total[3]. By trends in monthly trading volume of spot bonds, the trading volume was fairly stable, except for a big drop in February only, showing a YoY increase for each month. By trends in yield to maturity (YTM), yields fluctuate in a downward trend, showing notable divergence among terms. Yields of short-term bonds fell at a notably higher rate than that of medium- and long-term bonds.

Fig. 16: Each Month Saw a YoY Increase in Trading Volume of Spot LGFV Bonds



Source: choice, CCXI International Macro Interest Rates Database

Fig.17: Short-term Yields Fell Faster Than Medium- and Long-term Yields



Source: choice, CCXI International Macro Interest Rates Database

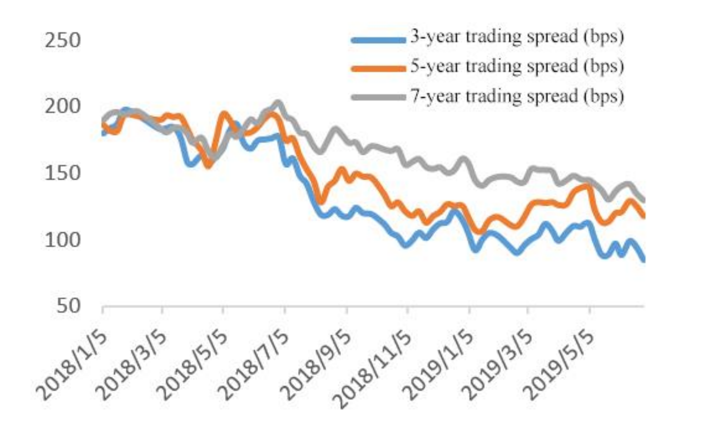
2. Credit Rating for the AA- rating narrowed the most compared with the end of last year, with Hainan Province seeing the widest, and still widening, credit spread compared with the end of last year.

By trading spread, in H1, the trading spread of LGFV bonds continued to narrow for all terms, with biggest contraction going to three-year bonds. **By credit rating,** the credit spread shrank for all ratings. AA- credit spread narrowed the most compared with the end of last year. In terms of monthly trend, however, higher-rating credit spread showed narrower contraction, while lower-rating credit spreads showed wider

[3] Only rated bonds are included in assessment.

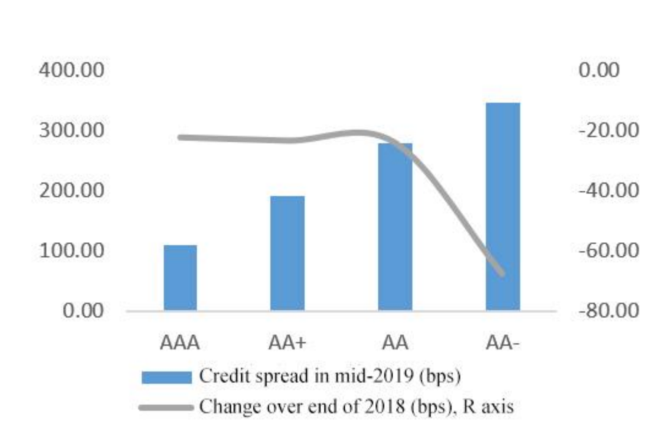
contraction. By geography, the credit spreads narrowed more or less in the vast majority of provinces, with Hainan Province recording the largest credit spread of LGFV bonds, which widened by 86 bps from the end of last year.

Fig. 18: Trading Spread of LGFV Bonds Continued to Narrow for All Terms



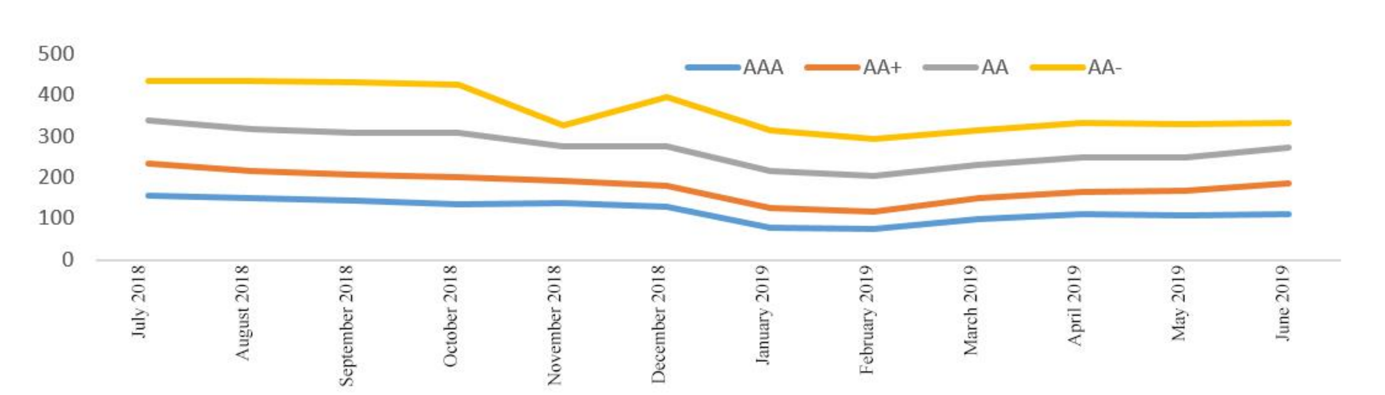
Source: choice, CCXI LGFV Industry Database

Fig.19: AA- Credit Spread Narrowed the Most Compared with the End of Last Year



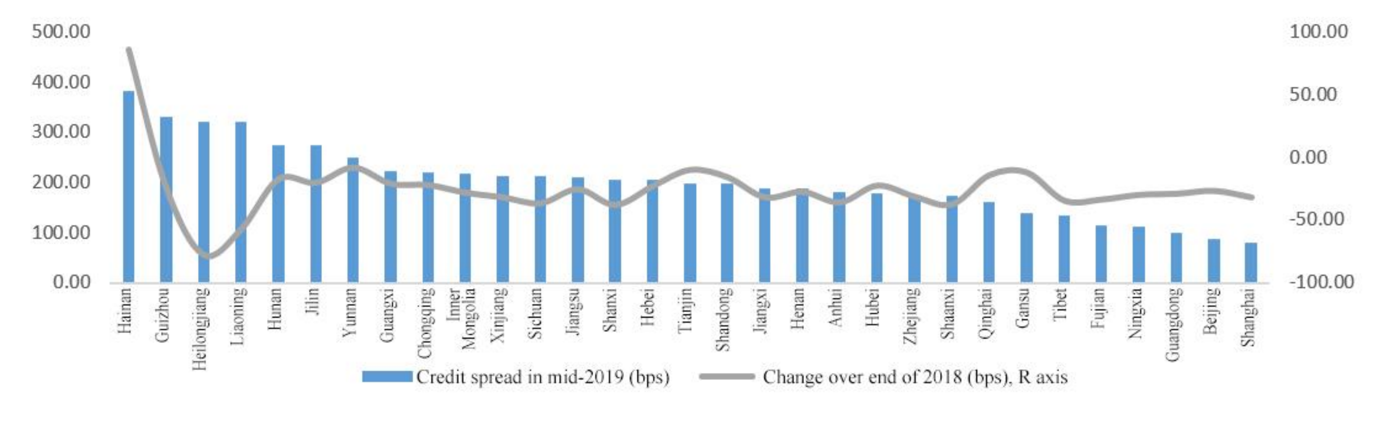
Source: choice, CCXI LGFV Industry Database

Fig.20: Credit Spreads Narrowed for All Ratings in 1H2019 Compared With the End of 2018, with AA- Spread Narrowing the Most



Source: choice, CCXI LGFV Industry Database

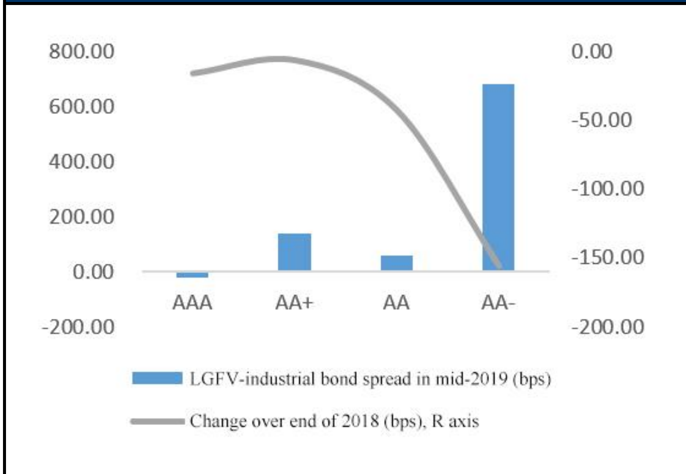
Fig. 21: Hainan's Credit Spread Was Significantly Wider Than at the End of Last Year, while All Other Provinces Registered a Contraction



Source: choice, CCXI LGFV Industry Database

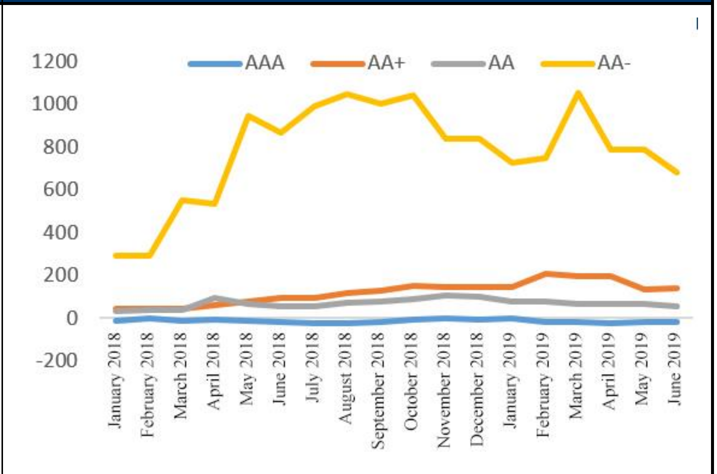
LGFV-industrial bond spread[4] continued to diverge. Specifically, the AAA rating showed the lowest LGFV-industrial spread among all ratings at -20.46 bps, down 16.18 bps from the end of 2018. The AA- rating recorded the highest spread of 682.86 bps, representing the largest contraction of 156.01 bps compared with the end of 2018. **By geography,** Guangdong and Jilin showed the widest interest rate spread between LGFV bonds and industrial bonds, which expanded compared with the end of last year. By contrast, Ningxia showed the narrowest LGFV-industrial spread, which shrank the most by more than 1,500 bps. **By monthly trends in rating-specific LGFV bonds,** LGFV bonds with AA- rating narrowed its spread the most with industrial bonds, while other ratings registered a fairly stable trend in the spread over industrial bonds. However, there are pronounced differences between ratings. The spread remained negative for AAA rating and was most volatile for AA-.

Fig.22: AA- LGFV-Industrial Spread Narrowed the Most



Source: choice, CCXI LGFV Industry Database

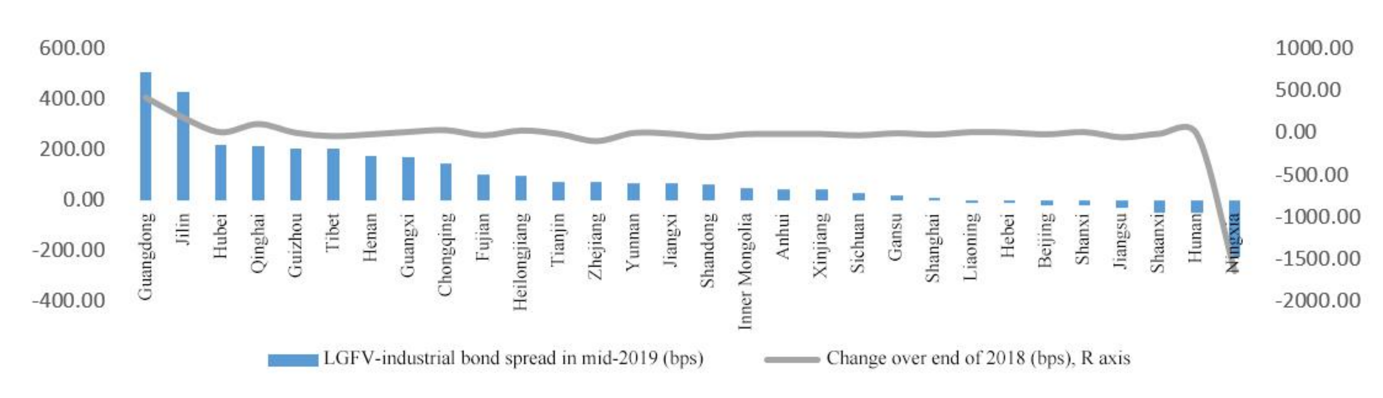
Fig.23: **LGFV-Industrial Spread Narrowed Substantially for AA- Rating**



Source: choice, CCXI LGFV Industry Database

Fig. 24: Guangdong, Jilin and Hubei Recorded Widest LGFV-Industrial Spread

[4]This report samples the LGFV bonds and industrial MTNs at mid-2019 to assess the LGFV-industrial bond spread. The LGFV-industrial spread is the ChinaBond Valuation yield of industrial bonds minus the ChinaBond Valuation yield of LGFV bonds.



Source: choice, CCXI LGFV Industry Database

II. Credit rating: All LGFVs saw their ratings upgraded, with non-standard debt defaults increasing by about two times YoY

i. Credit incidents: Non-standard debt defaults at lower administrative levels remained serious and defaults on trust products increased significantly

According to disclosed information, 17 LGFVs got involved in non-standard debt defaults in 1H2019, which has nearly tripled in number compared with the same period in 2018.

Non-standard debt defaults have shown the following characteristics in 2019 to date. **By geography,** defaulting issuers in the 17 cases were concentrated in debt-ridden areas in central and western parts of China, including Guizhou (5 cases), Inner Mongolia (4 cases) and Yunnan (2 cases), ranking in the top three by number of defaults. 65% of total defaults occurred in the three regions. **By administrative level,** non-standard debt defaults mainly occurred among LGFVs at the district/county level, with 12 cases, followed by municipal level (3 cases) and provincial level (only 2 cases). **By underlying product,** the main products in default were trust plans, with 12 cases recorded. Compared with one case in the same period last year, the number of trust plan defaults increased significantly. In addition, defaults involved three private placement products and two financial leasing products. **By underlying project,** defaults mainly involved the district/county-level LGFV projects where the borrowers are located, such as the standard workshop project of Jinqiao New Area Industrial Park in Pengxi County, the Nuoer Town Back Streets Renovation Project in Duolun County and the Resettlement Housing Project for Shantytowns Redevelopment in Kaili City. But limited disclosures are available for private placement fund products. **By type of default,** in addition to the non-standard credit defaults by LGFVs as borrowers, two LGFVs came into default as guarantors this year, namely, Ruzhou Communications Investment and Development Co. Ltd. in Henan and Duolun Chunhui City Investment Co., Ltd. in Inner Mongolia. Therefore guarantees-triggered defaults by LGFVs should not be underestimated. **By cause of debt default,** although the refinance policy for LGFVs companies was relaxed in the first half of this year, LGFV projects in financially weaker regions rely heavily on government payments or grants. Thus non-standard debt default is likely to occur when the government payments or grants are not in place in the peak period of debt service. **By follow-up action,** due to limited disclosure of non-standard debt information, the disclosed information shows tardy handling of non-standard debt defaults and only Chishui State-owned Assets Investment Co., Ltd. completed repayment.

In addition, unexpected credit incidents caused by personal factors of senior executives may not necessarily lead to rating downgrades or defaults, but are likely to impair operating and financing capacity of LGFVs. For example, the chairmen of Yunnan Metropolitan Real Estate Development Co., Ltd. and Yunnan Construction and Investment Holding Group Co., Ltd. were suspected of gross misconducts and violation of law. Media reports uncovered chairmen’s radical decisions on business development of the two companies.

As a result, the operation and governance of the two companies have been continuously questioned, adding to their debt risk.

Table 1: Credit Risk Incidents of LGFV Companies in 1H2019

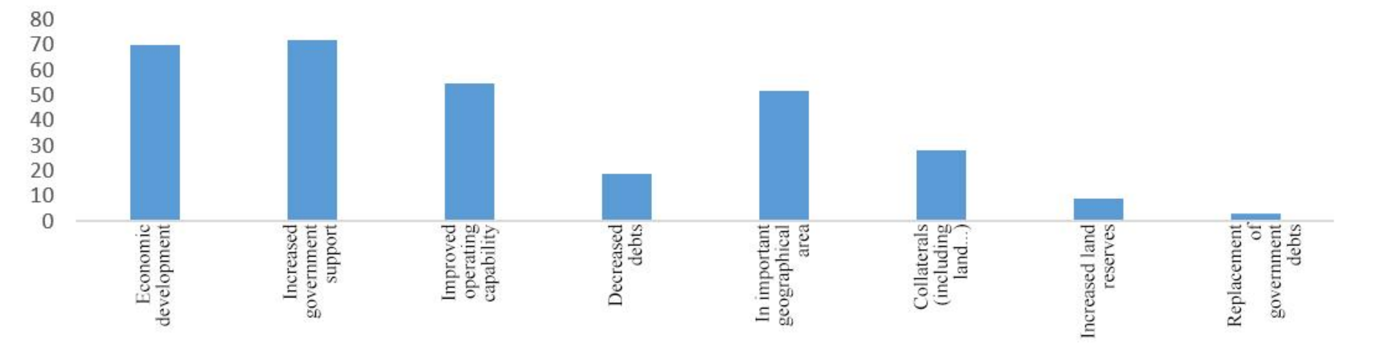
Name of company	Province	Administrative level	Type of debt involved	Name of product involved	date of incident
Rongjiang State-owned Assets Management Co., Ltd.	Guizhou	County/district	Asset management plans, private placement products	SPIC Xianrong Ruirong No. 1 Asset Management Plan, Guoxin No. 18 Private Placement Fund for Guizhou Qiannan Shengshan Avenue Project (Tranche IV)	December 2018, March 2019
Subsidiary of Tongliao City Investment Group Co., Ltd. (Kailu Lufeng Industrial Investment Co., Ltd.)	Inner Mongolia	County/district	Trust plan	China Jiangsu International ·Jinma No. 522 Kailu Lufeng Industrial Investment Pooled Fund Trust Plan	January 2019
Chishui State-owned Assets Investment Co., Ltd.	Guizhou	Municipal	Private placement products	Accounts receivable	January 2019
Ruzhou Communications Investment and Development Co. Ltd.	Henan	County/district	Trust plan	Sino-Australia Zhencheng No. 45 (Ruzhou Communications) Pooled Fund Trust Plan	January 2019
Alashan Infrastructure Construction Investment Co., Ltd.	Inner Mongolia	Municipal	Trust plan	Yinxiang No. 350 Pooled Fund Trust for Alashan Infrastructure Construction Investment Loans	February 2019
Guizhou Kaili Kaiyuan City Investment Development Co., Ltd.	Guizhou	Municipal	Trust plan	Zhongtai Pooled Fund Trust Plan for Guizhou Kaili Project Loans	February 2019, March 2019
Pengxi Jinfu Industrial Co., Ltd.	Sichuan	County/district	Trust plan	Zhongjiang Trust-Jinma No. 547 Pooled Fund Trust Plan for Pengxi Jinfu Industrial Accounts Receivable Investment (Tranche I)	March 2019
Duolun Chunhui City Investment Co., Ltd.	Inner Mongolia	County/district	Trust plan	Zhongjiang Trust ·Jinma No.508 Chunhui Investment Receives Investment Pooled Fund Trust Plan	March 2019
Longyang Guangxia Investment and Development Co., Ltd.	Yunnan	County/district	Trust plan	Jinma No. 419 Pooled Fund Trust Plan for Accounts Receive of Longyang Guangxia Investment and Development Co., Ltd.	March 2019
Shidian Tianyuan Water Supply Co., Ltd.	Yunnan	County/district	Trust plan	Yinxiang No. 402 Pooled Fund Trust Plan for Accounts Receive of Shidian Tianyuan Water Supply Co., Ltd.	March 2019
Qinghai Province Investment Group Co., Ltd.	Qinghai	Provincial	Trust plan	Zhongtai Hengtai No.18 Pooled Fund Trust Plan	March 2019
Yuqing State Owned Assets Investment and Management Corporation	Guizhou	County/district	Private placement funds	Guoxin No. 16 Private Placement Fund for Guizhou Zunyi Infrastructure Construction	March 2019
Guangxi Financial Investment Group City Development Corporation	Guangxi	Provincial	Trust plan	Chang'an Trust - Changanning Pooled Fund Trust Plan for GFIG Receivables Purchase under Resale Agreement	March 2019
Alashan Binhe Jinsha Development Co., Ltd.	Inner Mongolia	County/district	Financial leasing product	——	May 2019
Xi'an Weibei Investment Development Group	Shaanxi	County/district	Trust plan	Zhongtai • Yuantai No.3 Pooled Fund Trust Plan	May 2019
Xiangtan Jiuhua Economic Construction Investment Co., Ltd.	Hunan	County/district	A number of non-standard financing products	——	June 2019
Dushan Xiasi Investment and Development Co., Ltd.	Guizhou	County/district	Trust plan	Involving a number of PPNs, private placement bonds, asset management plans and trusts.	June 2019

Data Source: choice, CCXI LGFV Industry Database

ii. Rating adjustments: No downgrades occurred. The rating upgrades were mainly attributable to regional economic development, increased government support and improved operating capability

By issuer rating adjustment, no LGFV issuers had rating downgrades in H1. 79 LGFV issuers had their ratings upgraded, mainly due to local economic development, stronger government support and improved operating capability. **By facility rating adjustment**, 183 LGFV bonds had their ratings upgraded, 36 of which have higher facility ratings than their issuer ratings due to credit enhancement, which principally included pledge of land use rights and external guarantees. For upgrade details, please refer to the schedule at the end of the report.

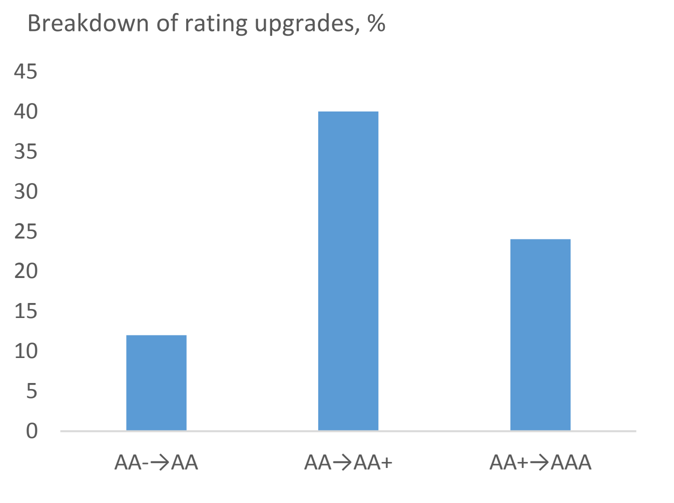
Fig. 25: LGFV Bonds Had Rating Upgrades Mainly Due to Local Economic Development, Increased Government Support and Improved Operating Capability



Source: choice, CCXI International Macro Interest Rates Database

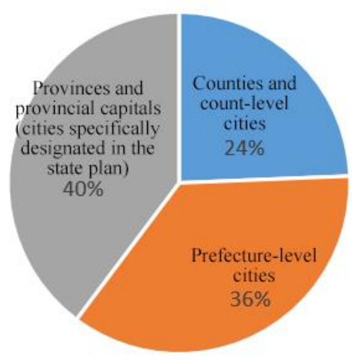
By breakdown of issuer rating upgrades in H1, issuer rating upgrades were mainly from AA to AA+, involving a total of 40 issuers. 12 issuers were upgraded from AA- to AA and 24 from AA+ to AAA. Three issuers have their outlook upgraded, with their issuer ratings remaining unchanged. **By administrative level of upgraded LGFVs,** provincial-level LGFVs took the dominance, accounting for 40% stably. **By geographical location of upgraded issuers,** East China saw markedly more upgrades than the central and western parts of China, with Jiangsu and Zhejiang leading the country by the number of issuer upgrades, i.e. 20 and 9 respectively.

Fig.26: Issuer Rating Upgrades from AA to AA+ Took Up the Biggest Share



Source: choice, CCXI International Macro Interest Rates Database

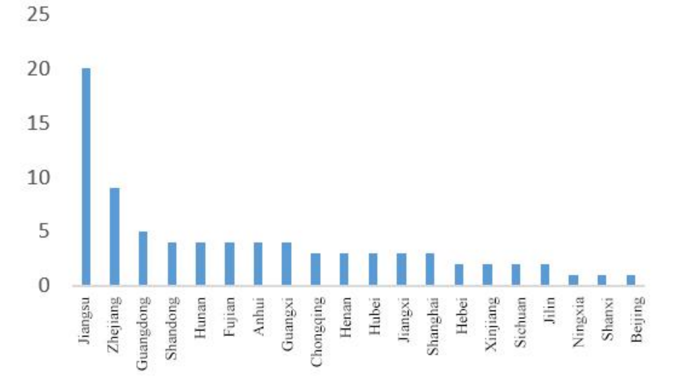
Fig. 27: Upgraded LGFVs Were Mainly at Provincial Level

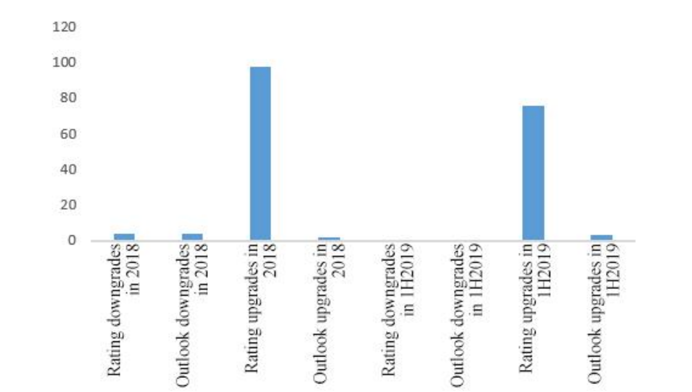


Source: choice, CCXI International Macro Interest Rates Database

Fig. 28: Jiangsu Had the Largest Number of LGFV Upgrades

Fig. 29: No LGFVs Had Issuer Rating Downgrades in 1H2019





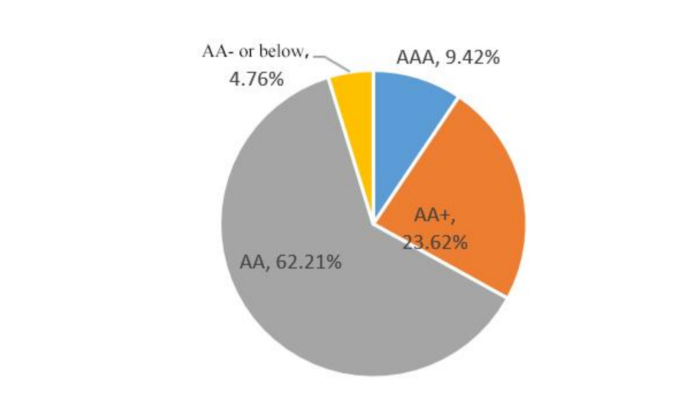
Source: choice, CCXI International Macro Interest Rates Database	*Source: choice, CCXI International Macro Interest Rates Database*

In terms of rating downgrades, LGFVs had neither issuer nor facility rating downgrades in 1H2019. By contrast, 2018 saw issuer rating or outlook downgrades for eight LGFVs, of which four had rating upgrades and the other four had outlook downgrades. Downgrades resulted from weaker local financial capacity, greater short-term debt service pressure, deteriorating revenue, poorer asset quality and liquidity and greater uncertainty in collection of receivables. It is worth noting that, **of LGFVs upgraded this year, Yuzhou Investment Corporation was downgraded to AA- last year**, mainly due to poor collection of receivables, sharp increase in accounts receivable from government, serious decline in asset quality, substantial profit distribution resulting in a decrease in disposable cash and slow progress in underlying projects of two bonds. In June this year, Yuzhou Investment Corporation was upgraded to AA mainly because of the improved collection of receivables. Yuzhou Municipal Finance Bureau has planned to repay the company's governmental debts in installments, supplemented by the local SASAC's plan to inject at least RMB 5 billion of effective assets into the company in 3 to 5 years.

iii. Early redemption: The scale of early redemption shrank YoY. The share of medium- and high-rating bonds rebounded

The scale of early redemption gradually retreated as the swap of local government debts was drawing to a close at the end of last year. In 1H2019, early redemptions amounted to RMB169.231 billion, down 39.11% YoY. According to the local government debt report published by the Ministry of Finance, however, there were still about RMB303.7 billion of non-bond local government debt remaining outstanding at the end of June. If this part of debt is refinanced in the future, the early redemption will be increased. In 2019, some LGFVs have begun to swap hidden debts for CDB loans carrying lower interest rates. The completed swaps may increase the future scale of early redemptions. **By geography,** Jiangsu, Zhejiang, Hunan and Chongqing were the top four by scale of early redemption, recording RMB29.586 billion, RMB16.607 billion, RMB15.758 billion and RMB11.330 billion in total early redemption, respectively. **By issuer rating of LGFVs**, early redemptions were mainly AA rated, which accounted for 62.21%, up 0.56 percentage point YoY. The proportion of AA+ and higher ratings rose by 1.57 percentage points YoY. **By proportion of LGFV bonds issued before 2014** ("old LGFV bonds"), old LGFV bonds accounted for 50.40% in 1H2019, down 38.21 percentage points YoY.

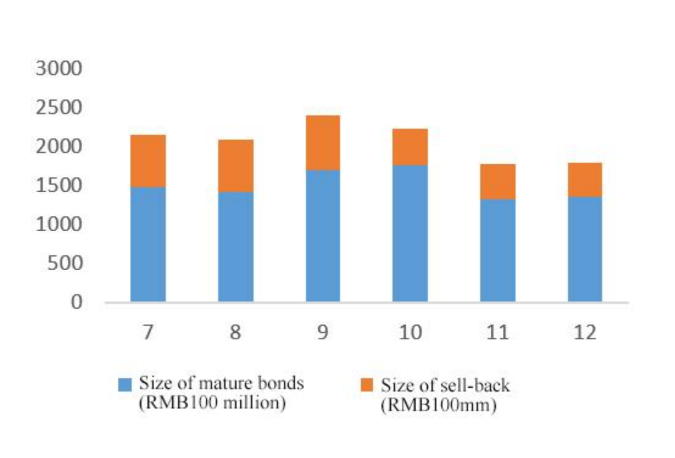
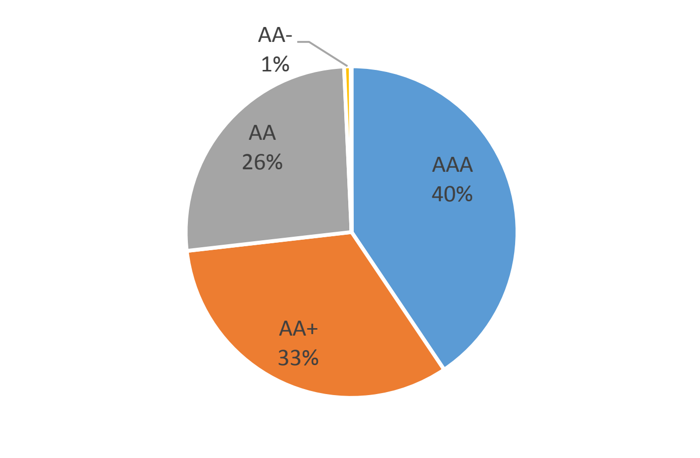
Fig. 30: Scale of Early Redeemed LGFV Bonds Shrank in H1 YoY	**Fig. 31: Early Redeemed LGFV bonds Were Mainly AA Rated**

	
Source: choice, CCXI International Macro Interest Rates	*Source: choice, CCXI International Macro Interest Rates*

III. Maturity status: The average monthly size of bonds to mature between July and December exceeds RMB100 billion, posing a still-large debt rollover pressure

i. The maturity and sell-back pressure will be high in September, and the issuer ratings of maturing bonds are still mainly medium to high

Overall, LGFV bonds are still under a large maturity and sell-back pressure. **LGFVs bonds due to mature and sell back[5] in July to December exceed RMB1.2 trillion, of which 73% are due to mature and 27% to sell back.** The maturity and sell-back pressure is particularly heavy in September with a scale of over RMB240 billion. **By issuer credit rating,** the issuers of bonds due to mature and sell back are mainly AAA rated, exceeding RMB500 billion in size and accounting for about 40%. **By way of bond issuance,** public offerings took up the largest share of about 80%, while the rest were private placements. **By type of bond,** SCPs accounted for the largest percentage (about 33%) of bonds due to mature and sell back, exceeding RMB400 billion in scale. Corporate bonds, PPNs, MTNs and enterprise bonds accounted for about 4%, 15%, 13% and 9% of total bonds due to mature and sell back, respectively.

Fig. 32: September Will See the Largest Maturity and Sell-back Pressure	Fig. 33: LGFV Bonds Due to Mature and Sell Back Are Mainly AAA Rated
	
Source: choice, CCXI International Macro Interest Rates	*Source: choice, CCXI International Macro Interest Rates*

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[5]Bonds due to mature are LGFV bonds outstanding at June 30, 2019.

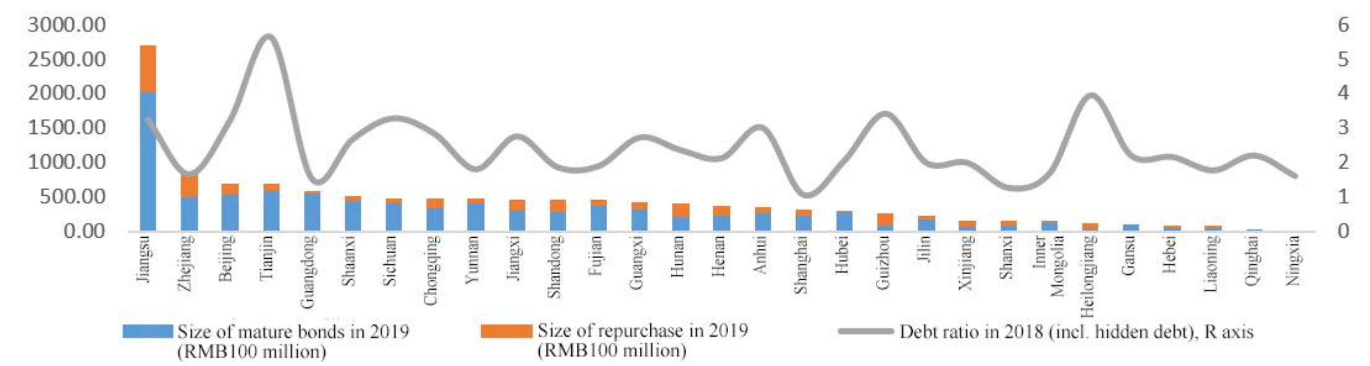
Database	*Database*

ii. Jiangsu Province still has the largest scale of maturing bonds. The bonds with special terms and conditions continue to expand as a percentage of total

By geography, Jiangsu Province ranks first by scale of LGFV bonds due to mature and sell back in 2H2019 (more than RMB270 billion), followed by Zhejiang (over RMB80 billion), and Beijing and Tianjin (both close to RMB70 billion). However, some provinces with high debt ratios[6] such as Gansu, Xinjiang, Heilongjiang and Ningxia have a small scale of LGFV bonds due to mature and sell back, all below RMB20 billion. But Tianjin, Shaanxi and Beijing show both high debt ratios and large scale of bonds due to mature and sell back, felling a relatively high maturity and sell-back pressure. **By new or old LGFV bonds,** of LGFV bonds to mature or sell back, old LGFV bonds issued before the end of 2014 amounted to 270 billion, accounting for about 22%, down about 4 percentage points from the end of 1Q2019.

By special bond terms and conditions, the bonds with special terms and conditions accounted for 50.27%, up about 2 percentage points over the end of last year. Of all the special terms and conditions, **"coupon rate adjustments"** accounted for 55.35%, down about 3 percentage points from the end of last year; **"cross default"** accounted for 23.65%, up about 11 percentage points from the end of last year; **"prior restraints"** and **"change of control or controller**" were 22.99% and 2.38% respectively, both rebounding from the end of last year.

Fig. 34: Jiangsu Has the Biggest Scale of Bonds Due to Mature and Sell Back in 2H2019



Source: choice, CCXI Regional Risk Database and CCXI City Infrastructure Industry Database

iii. More than 60% of the issuers involved in maturing or sell-back show insufficient operating cash flows to cover interest-bearing debts

In 2019, up to the end of June[7], the LGFV bonds involving 793 LGFV firms got matured or sold back. Their overall solvency is still weak. **In terms of liabilities-to-assets ratio,** LGFV companies' overall debt pressure slightly rebounded from the end of last year. Their liabilities-to-assets ratios averaged 60.62%, up 1.43 percentage points, with a median of 61.59%, up 0.54 percentage point. In terms of solvency, over 60% of LGFV companies were unable to cover interest-bearing debts with their operating cash flows. Issuers were under an obviously higher pressure of serving debts with own operating cash flows than at the end of last year, and relied more on refinancing and realization of current assets increased. In addition, the average and median of current ratios of LGFVs companies were 2.71 and 2.12 respectively, and the average and

[6] Including implicit debts

[7] All semi-annual data are not available, so here calculations are based on Q1 financial statements of LGFV firms.

median of quick ratios were 1.44 and 1.19 respectively, a decline from the end of last year. **In terms of asset liquidity**, the average and median of other receivables as a percentage of current assets of LGFVs companies were 20.93% and 16.15% respectively, showing little change compared with the end of last year. But the data still showed issuers' strong reliance on government payments. By province, Gansu and Jilin showed a high ratio (over 35%) of other receivables to current assets, indicating weak liquidity of assets.

Fig.35: Short-term Solvency of Issuers with LGFV Bonds to Mature in July to December, by Province

Source: choice, CCXI Regional Risk Database and CCXI City Infrastructure Industry Database

IV. Outlook: Opportunities and risks coexist. Due attention should be paid to structural opportunities in the context of LGFVs' mixed performance

In H1, the money market maintained reasonably ample liquidity, saw interest rates falling. **The primary and secondary markets of LGFV bonds recovered markedly.** Issue interest rates and yields to maturity were on the decline overall, with interest rate spread narrowing further. However, **LGFV bonds are subject to market-oriented transformation requirements and show rising structural divergence**. LGFVs that undertake major projects in key fields and weaker sectors will receive more support[8], so as to mitigate the liquidity risk of relevant LGFV companies. But support will remain limited for LGFVs in financially weaker areas and at low administrative levels. **In H2, LGFVs will still face a heavy debt service pressure.** Macro-economic leading indicators declined[9], posing **additional downside pressure to the economy**. Forestalling risks will remain the focus of the LGFV regulatory policies. On the whole, opportunities and risks coexist in the LGFV industry in the next stage. Focus should be placed on the following aspects:

i. Pay attention to the positive effects of the *Notice on Working Hard on Special Local Government Bonds and Companion Financing of Projects* on LGFVs.

In response to the sustained downside pressure to the domestic economy, the Notice allows special bonds to be used as eligible capital instrument for major projects to improve the work on special bonds-based project financing. The move meets the current policy requirement of balancing "stable growth" and "risk prevention" and further strengthens infrastructure construction as the cornerstone of economic growth. As for the LGFV industry, the Notice provider greater clarity on the role of LGFVs. The mixed financing model that combines "special bonds" with "market-oriented financing", as introduced in the Notice, will dispel the worries of

8 The *Notice on Working Hard on Special Local Government Bonds and Companion Financing of Projects on LGFVs* has a positive effect on some LGFVs seeking finance for major projects.

9 Real estate sales, land acquisition and sources of funding receded, PMI orders and PMI export orders went down, and a series of tightening policies on real estate financing were issued in succession. In addition, medium- and long-term corporate loans took up a smaller share of aggregate financing, while short-term loans and CPs accounted for a larger percentage.

financial institutions in lending to LGFVs and improve their future access to financing. In particular, LGFVs undertaking major projects in the fields of transport, rail and water conservancy will receive more support.

ii. Pay due attention to the positive effects of hidden debt reduction and market-oriented transformation of LGFVs

The government's push to defuse the hidden debt bomb helps relieve the debt rollover pressure on LGFVs and reduce their cost of debts. Swapping hidden debts for lower-interest-rate CDB loans leaves more time and creates favorable conditions for LGFVs to transform the business model, improve quality and efficiency and enhance profitability and solvency. To date, the only successful case of debt swap recognized by the head office of CDB is the transportation-related government debt swap of Shanxi Province. CDB has successfully helped relieve the debt service pressure of Shanxi Transportation Holdings. CDB's participation in debt swap in Zhenjiang has been making headlines since 2019 began. The issue interest rate of LGFV bonds in Zhenjiang has dropped somewhat on media reports. Subsequently news came out on debt swap discussions between local governments and local CDB branches in Nanjing in Jiangsu, Xiangtan, Changde in Hunan, Tianjin and Zunyi in Guizhou. If these localities start to refinance hidden debts with CDB loans in the next stage, they might see the same trends in the issue interest rate of LGFV bonds as in Zhenjiang in the current interest rate environment. However, the debt-for-CDB loan swap has not reduced the total size of hidden debts. It is still necessary to guard against risk transfer from local areas to the financial industry.

In addition, LGFVs continues with transformation. Some LGFVs have their existing good resources merged to create a holding group. As the new company engages in a broader range of industries, its operating income will increase to unleash the economics of scale, reduce administrative and operating costs and improve the profitability of relevant LGFVs. After Chongqing Water Group merged with Chongqing Water Conservancy Investment Group, and after Jianan Investment Holding Group in Bozhou City, Anhui Province put together multiple local LGFVs in various industrial sectors to form a diverse business group, the new company has improved its profitability significantly compared with that before the merger. Its bigger scale has turned into a notably higher position in the locality and additional local government support.

iii. Look for opportunities for LGFVs in the renovation of aging residential communities

The June 19 executive meeting of the State Council introduced a plan to carry out a pilot program on the renovation of aging urban residential commodities (the "Renovation Program") this year. According to the *Notice on Renovation of Old Residential Communities in 2019* issued by three central authorities including the Ministry of Housing and Urban-Rural Development (MOHURD), the Renovation Program helps stabilize investment and comes as a multi-pronged move to achieve stable growth, enable structural adjustments and improve public well-being. The Renovation Program is of great help to the issuance of LGFV bonds. As the efforts to strengthen weaker areas of infrastructure have expanded in scope, the local project revenue bonds alone still cannot cover all project financing demands. In addition, this year financial institutions and local governments will be encouraged to actively explore the use of market-oriented methods to attract private-sector resources to the Renovation Program. Moreover, the Renovation Program requires the development of various supporting services in addition to renovation, including community-based elder care, childcare, medical care, food and cleaning services. Therefore, LGFVs participating in relevant renovation projects will receive more government support and increase their operating profits, thus improving the credit standing of these LGFVs.

iv. Pay due attention to non-standard debts and contingent debts of LGFVs to prevent risk resonance

In 1H2019, the non-standard debt defaults by LGFVs occurred slightly more frequently than last year. LGFV bonds issued by the issuers of some non-standard products **had cross-default clauses**, putting relevant bonds at the risk of default triggered by non-standard debt defaults. For example, a subsidiary of Tongliao City Investment Group Co., Ltd. (Kailu Lufeng Industrial Investment Co., Ltd.) got involved in non-standard debt default, while other bonds issued by the common issuer contained cross-default clauses. Thus after the non-standard default occurred, the issuer had to allocate resources to repay the principal plus interest of the debt covered by cross-default clauses in a timely manner and avoided default on relevant bonds. In addition, **LGFVs' contingent debts still deserve due attention to guard against the risk resonance triggered by mutual guarantees.** Among the defaults in H1, two LGFVs companies in Inner Mongolia, Alashan Infrastructure Construction Investment Co., Ltd. and Alashan Binhe Jinsha Development Co., Ltd., provided guarantees for each other. Successive defaults by the two LGFVs have highlighted the heavy debt pressure and poor operating conditions of local LGFVs. Any peak in debt service is likely to trigger risks spreading across the region.

v. Pay due attention to the credit risk of LGFVs in financially weaker regions amid the higher downside pressure to the macro-economy

The downward pressure on the economy has remained high and the proactive fiscal policy has increasingly strengthened in 2019 to date. In H1, government expenditure reached RMB12,353.8 billion, up 10.70% over one year earlier, showing a continued acceleration. The public finance expenditure pressure has increased in all regions over the previous year. However, as central and western regions have obviously lower government revenue than eastern provinces, infrastructure enhancement projects in the central and western regions may be bottlenecked by the weaker local financial capacity. Thus local LGFVs may face greater financing risks than those in the eastern regions due to the limited external support available. In particular, extra attention should be paid to LGFVs in these areas at lower administrative levels and to those showing a large proportion of government receivables in their assets and heavy reliance on government subsidies.

Schedule: List of LGFVs with Rating Upgrades in 1H2019

Issuer	Current issuer rating	Last issuer rating	Province	Reason for upgrade							
				Economic development	Government support	Income growth	Debt decline	Important position	Guarantees	Increased land reserve	Debt swap
Zhucheng Economic Development and Investment Corporation	AA+	AA	Shandong	√	√	√		√	√		
Zhuhai Huafa Integrated Development Co., Ltd.	AAA	AA+	Guangdong	√		√		√			
Chongqing Yuelai Investment Group Co., Ltd.	AA+	AA	Chongqing	√		√	√				
Chongqing Yuzhong State-owned Assets Management Co., Ltd.	AA+	AA	Chongqing	√	√	√	√	√			
Chongqing Xinliang Investment Development (Group) Co., Ltd.	AA	AA-	Chongqing	√	√	√		√	√		
Zhengzhou Airport Xinggang Investment Group Co., Ltd.	AAA	AA+	Henan	√	√	√					
Changxing Communications Investment Group Co. Ltd.	AA+	AA	Zhejiang	√		√	√	√			√
Changxing City Construction Investment Group Co., Ltd.	AA+	AA	Zhejiang	√	√	√	√				
Changsha Pilot Investment Holdings Group Co., Ltd.	AAA	AA+	Hunan	√	√	√		√	√	√	
Changsha Yuhuashi Urban Construction Investment Group Co., Ltd.	AA+	AA	Hunan	√	√	√		√	√		
Zhangzhou Jiulongjiang Group Co., Ltd.	AA+	AA	Fujian		√	√		√			
Zhangzhou Communications Development Group Co. Ltd.	AA+	AA	Fujian	√	√	√	√	√			

Yuzhou Investment Corporation	AA	AA-	Henan	√	√	√	√	√	√		
Yuyao Economic Development Zone Construction Investment & Development Co. Ltd.	AA	AA-	Zhejiang	√	√				√		
Yinchuan Urban Construction Investment Holding Co., Ltd.	AA+	AA	Ningxia	√	√		√	√			
Yiwu Water Construction Group Co., Ltd.	AA	AA-	Zhejiang								
Yangzhou Hanjiang Construction Development Co. Ltd.	AA+	AA	Jiangsu	√	√			√			
Yangzhou Guangling Xincheng investment Co. Ltd.	AA	AA	Jiangsu	√	√			√	√	√	
Yancheng Haicing Group Co., Ltd.	AA+	AA	Jiangsu		√	√	√	√			
Xuancheng Economic and Technological Development Zone Construction Investment Co., Ltd.	AA	AA-	Anhui	√	√	√			√		
Xuzhou Xinsheng Investment Holding Group Co., Ltd	AAA	AA+	Jiangsu	√	√	√		√		√	
China Suntien Green Energy Co., Ltd.	AAA	AA+	Hebei								
Xinjiang Tianfu Group Co., Ltd.	AA+	AA	Xinjiang		√	√		√			
Xiangxiang Dongshan Investment and Development Group Co., Ltd.	AA	AA-	Hunan	√	√			√	√		
Wuhan State-owned Assets Management Co., Ltd.	AAA	AA+	Hubei		√	√	√	√			
Wuxi Taihu New City Development Group Co. Ltd.	AAA	AA+	Jiangsu	√	√			√	√		
Urumqi Economic and Technological Development Zone Construction and Development Corporation	AA+	AA	Xinjiang	√	√			√			
Tongcheng City Construction Investment Development Co., Ltd.	AA	AA-	Anhui	√	√	√	√	√			
Taizhou Communications Industry Group Co. Ltd.	AA+	AA	Jiangsu	√	√			√			√
Taizhou Hailing City Development Group Co., Ltd.	AA+	AA	Jiangsu	√	√	√		√	√		
Taicang Loucheng High-tech Construction Co., Ltd.	AA+	AA	Jiangsu								
Suzhou SND Group Corporation	AAA	AA+	Jiangsu	√	√	√		√	√		
Suzhou Xiangcheng Urban Construction Investment (Group) Co., Ltd.	AA+	AA	Jiangsu	√	√			√	√		
Shaoxing Jinghu New Area Development Group Co. Ltd.	AA+	AA	Zhejiang	√	√	√		√			√
Shaodong New Area Development and Construction Investment Co., Ltd.	AA	AA-	Hunan	√	√			√	√		
Shangrao City State-owned Assets Management Group Co., Ltd.	AA+	AA	Jiangxi	√	√	√					
Shanghai Shibei Hi-Tech (Group) Co., Ltd.	AAA	AA+	Shanghai	√	√	√					
Shanghai Lingang Holdings Co Ltd.	AAA	AA+	Shanghai	√	√	√		√			
Shanghai Gold Bund (Gorup) Development Co.,Ltd.	AA+	AA	Shanghai	√	√	√					
Shandong Railway Investment Holding Group Co., Ltd.	AAA	AA+	Shandong	√	√	√		√			
Shandong High-tech Innovation Investment Group Co., Ltd.	AA+	AA	Shandong	√	√	√	√	√			
Qidon City Construction Investment and Development Group Co.,	AA+	AA	Jiangsu	√	√	√	√		√		

Ltd.											
Ningbo Zhenhai Investment Co., Ltd.	AA+	AA	Zhejiang	√	√	√	√	√	√		
Ningbo Meishan Island Development & Investment Co., Ltd.	AA+	AA	Zhejiang	√	√	√					
Ningbo Hangzhou New Zone Development & Construction Co., Ltd.	AA+	AA	Zhejiang	√	√	√		√		√	
Nantong Chongchuan City Construction Investment Group Co., Ltd.	AA+	AA	Jiangsu	√	√	√					
Nantong High-Tech Industrial Development Zone Corporation	AA+	AA	Jiangsu	√	√	√			√		
Nanjing Zhongshan Assets Management Group Co., Ltd.	AA+	AA	Jiangsu								
Nanjing Jianye High-tech Investment Group Co., Ltd.	AA+	AA	Jiangsu	√	√				√		
Nanchang City Construction Investment and Development Group Co., Ltd.	AAA	AA+	Jiangxi	√	√			√	√		
Mianzhu Golden Investment Group Co., Ltd.	AA	AA-	Sichuan	√	√	√		√	√		
Maanshan Zhengpu Port New Area Construction Investment Co., Ltd.	AA	AA-	Anhui	√	√	√		√	√		
Longxiang Investment Holding Group Co., Ltd	AA+	AA+	Jilin	√	√	√					
Liuzhou Dragon Investment Development Co., Ltd.	AA+	AA	Guangxi	√	√	√				√	
Red Flag Canal Economic and Technological Development Zone Huitong Holding Co., Ltd.	AA	AA-	Henan	√	√				√		
Liyang City Construction and Development Group Co., Ltd.	AA+	AA	Jiangsu	√	√		√				
Jingshan Jing Cheng Investment Development Co.,Ltd.	AA	AA-	Hubei	√	√	√		√	√		
Jincheng State-Owned Capital Investment Operation Co., Ltd.	AA+	AA	Shanxi	√	√	√		√			
Jiangxi Railway Investment Group Corporation	AAA	AA+	Jiangxi	√	√	√	√	√			
Jiangsu Huajing Assets Management Co., Ltd.	AA+	AA	Jiangsu	√	√			√		√	
C&D Real Estate Corporation Limited	AAA	AA+	Fujian		√	√		√	√	√	
Jinan Rail Transport Group Co., Ltd.	AAA	AA+	Shandong	√	√			√		√	
Hebei Construction Transportation Investment Group Co., Ltd.	AAA	AA+	Hebei	√	√	√		√	√		
XETZ State-owned Assets Management Co., Ltd.	AA+	AA	Zhejiang	√	√	√					
Hanjiang Guotou Group Co., Ltd.	AAA	AA+	Hubei	√	√	√					
Guangzhou Hi-tech Investment Group Co., Ltd.	AA+	AA	Guangdong	√	√						
Guangxi Communications Investment Group Co., Ltd.	AAA	AA+	Guangxi	√	√	√	√				
Guangxi Beibu Gulf Investment Group Co., Ltd.	AAA	AA+	Guangxi	√	√	√		√			
Guangxi Beibu Gulf International Port Group Co., Ltd.	AAA	AA+	Guangxi	√	√		√	√			
Guangdong Highway Construction Co., Ltd.	AA+	AA+	Guangdong	√	√	√			√		
Guangdong Nanhai Holding Investment Co., Ltd.	AAA	AA+	Guangdong	√	√	√	√	√			
Fujian Construction Engineering Group Co., Ltd.	AA+	AA	Fujian	√	√	√	√				

Tongxiang City Construction Investment and Development Group Co., Ltd.	AA+	AA	Jiangsu	√	√	√		√			
Dongguan Communications Investment Group Co., Ltd.	AAA	AA+	Guangdong	√	√	√		√			
Chuzhou Tongchuang Construction Investment Co., Ltd.	AA+	AA	Anhui	√	√	√		√	√		
Chengdu Shuangliu Xingcheng Construction Investment Co., Ltd.	AA+	AA	Sichuan	√	√	√		√	√		
Changzhou Investment Group Co., Ltd.	AA+	AA	Jiangsu	√	√			√			
Changzhou Urban Construction (Group) Co., Ltd.	AAA	AA+	Jiangsu	√	√			√			

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