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As the LGFV Bonds to Be Issued in 2021 May Reach RMB 4.3-4.6 Trillion, Particular Attention Needs to be Paid to the Structural Risks Possibly Arising from the Peak Maturity

Hong Kong, 25 January 2021-- China Chengxin International Credit Rating Co., Ltd. ("CCXI") issued a report entitled *"As Financing Supply May Be Tightened due to the Return of Policies to A Normal State, Particular Attention Needs to Be Paid to the Structural Risks Arising from LGFV Bonds at the Upcoming Maturity Peak"*.

According to the report, in 2020 when a series of countercyclical policies continued to take effect, the bond market managed to deliver an improved financing environment, and the Local Government Financing Vehicle ("LGFV") bonds surged significantly in both issuing size and net financing amount. Looking into 2021, stimulated by the strong refinancing demand, LGFV bonds will continue to expand with the issuing scale possibly ranging between RMB4.3-4.6 trillion. At the same time, investors need to take note of the debt service pressure facing some weak-qualified enterprise at the upcoming maturity peak, as well as the structural divergence among the enterprises that may occur when they are striving to dispose of hidden debts and pushing forward the new infrastructure and new urbanization initiatives as well as major projects constantly.

As pointed out by the report, 2020 saw a sharp surge in the LGFV bonds both issued and traded thanks to an overall loose credit environment, which was mainly credited to the intensified macro counter-cyclical adjustments in an attempt to withstand the impact of COVID-19 from early 2020. As the economy recovered gradually, the margin of monetary policy was tightened, and by the end of the year interest rates basically returned to the same level of last year after a V-shape movement. Seen from the primary market, the LGFV bonds issued in 2020 amounted to RMB4.49 trillion, a year-on-year increase of about 28%, and the net financing amount of such bonds stood at RMB1.93 trillion, representing a year-on-year increase of 48%. The issuance interest rate experienced a trend of first decline and then rise, and remained slightly lower at the end of the year compared with the same period of 2019. In terms of issuance structure, corporate bonds accounted for more than 30%, still ranking the first place. The ratio of roll-over bonds continued rising year-on-year and went beyond 80% throughout the year. There was an obvious trend of shorter terms. From the perspective of the secondary market, the trading volume of spot LGFV bonds approached RMB9.80 trillion, a year-on-year increase of 21%; the yield to maturity (YTM) began to rise after hitting the trough in April, and went back to the prior year-end level at the end of December 2020. In the meantime, the credit spreads of LGFV bonds revealed a trend of first widening and then narrowing as a whole, which intensified the structural divergence. Geographically, Guizhou, Liaoning and Jilin presented the fairly considerable credit spreads, which were all higher than their prior year-end level. In addition, the weak-qualified enterprises located in the places which are economically and financially weak and lower at administrative levels are prone to volatile prices in bond transactions. Particular attention should be paid to

the regions where abnormal transactions take up a relatively high share, such as Qinghai, Liaoning and Inner Mongolia.

The enterprises whose bond credit ratings were upgraded still made up the majority in 2020, but the number of credit incidents increased slightly compared with that in 2019.

As to the corporate credit ratings of enterprises, upgrades also predominated, and the number of enterprises given a higher rating reached 118, an increase of 42% over 2019. Most of them were the enterprises from the financially powerful prefectures, and the upgrade from “AA” to “AA+” prevailed. The overwhelming majority of upgrades could be attributed to the fact that the enterprises presented sound business/development prospects, occupied a position of increased importance, and demonstrated enhanced capital strength during the observation period. On the flip side, there were six enterprises seeing their corporate credit rating downgraded, a number going up 20% compared with 2019. The primary reasons behind such downgrades included the existence of contingent liability risks, high pressure from short-term debt repayment, deteriorating revenue, and considerably uncertain recovery of receivables. Most of the downgraded enterprises were distributed in the financially weak provinces such as Jilin, Qinghai, Inner Mongolia, Liaoning and Guizhou. The report also noted that in the context of the globally-sweeping pandemic and the mounting pressure from economic downturn, the LGFV bonds in some regions were affected to a certain extent, resulting in the declining profitability and the liquidity pressures. Negative credit events are still increasing in number. According to public information, 31 credit incidents related to non-standard bond assets occurred in 2020. The number in 2019 was 30. Besides, there was a trend that such credit incidents started to spread from non-standard assets to bonds.

Looking into the future, economic operations still face a certain level of uncertainty, and policies need to maintain their stability and continuity. Coupled with high refinancing needs, LGFV bonds will continue to expand. The issuing volume may range between RMB4.3-4.6 trillion, with different put-back ratios taken into account. The Central Economic Work Conference for 2021 proposed that “the prudent monetary policy should be flexible, precise, reasonably moderate, keep the growth rate of money supply and social financing basically matching the nominal economic growth rate, and keep the macro leverage ratio basically stable.” In combination with the above requirements, the report forecast that social financing may grow somewhat slower in 2021. Provided the growth rate edges down to about 11%, social financing available by the end of 2021 may hit about RMB316 trillion. It is assumed that the proportion of corporate bonds and asset-backed securities attributable to deposit-taking financial institutions in social financing remains at the current level. Combined with the proportion of the existing LGFV bonds in credit bonds, it is estimated that the LGFV bonds available at the end of 2021 may amount to RMB11.5 trillion, and the net financing amount throughout the year will approach about RMB1.1 trillion. Additionally, based on the LGFV bond refinancing needs, the proportion of new bonds in those due in the year, and the ratios of put-back bonds, the report estimated that the bonds due and put back throughout 2021 will range between RMB3.2-3.5 trillion and the LGFV bonds issued throughout the year will amount to RMB4.3-4.6 trillion.

Finally, as LGFV bond maturity is set to peak, investors need to be alert to the debt repayment risks caused by some weak-qualified enterprises as well as the structural divergence among these enterprises that may occur while they are striving to dispose

of hidden debts and continuing to push forward the new infrastructure and new urbanization initiatives as well as major projects constantly. First, particular attention should be paid to the mounting debt repayment pressure and the spreading guarantee risks arising from the weak-qualified enterprises as policies return to a normal state. In 2021, the amount of LGFV bonds due and put back will soar significantly to approach RMB3 trillion combined. Furthermore, the worsened qualifications of related entities may intensify the divergence among LGFV bonds. When enterprises suffer from the deteriorative financing capacity and solvency, investors should stay vigilant against the spreading risks of the weak-qualified enterprises due to the defaults of non-standard assets and guaranteed compensation over loans. **Second, it is necessary to track the divergence of credit strength among enterprises against the background when the exchanges rolled out a red, yellow, and green three-bracket zoning management policy.** According to recent media reports, the exchanges may divide LGFV bonds into different brackets for tiered issuance management according to local governments' debt ratios and revenues, in the hopes of restricting bond issuance. If the new policy is actually implemented, some enterprises located in the regions where local governments suffer from high debt ratios risk having to face the further tightened financing environment, a situation which will exacerbate the divergence among the enterprises. **Third, it is important to follow up with the credit strength divergence among the counties that are pushing forward the disposal of hidden debts on a trial basis.** In 2020, to mitigate the risks of hidden debts, various regions successively adopted a diversity of measures, which included bond swaps, loan swaps with financial institutions, and incorporation of debt resolution funds. In the process, the pilot program where counties used local government bonds to dispose of debts expanded its coverage step by step. However, given their debt risks are varying, these counties have progressed differently in debt disposal. As a result, they will exert the divergent effects on the credit strength of LGFV bonds. **Fourth, another points that merits particular attention is the risk divergence among the enterprises in their pursuit of transformation and further development as part of the efforts to push forward the new infrastructure and new urbanization initiatives as well as major projects.** With the gradual recovery of the economy, large-scale fiscal policy tools may be phased out step by step. In this context, the quotas for new special bonds are expected to go down slightly. But the majority of them will continue to be channeled to the new infrastructure and new urbanization initiatives as well as major projects. The enterprises qualified to participate in these initiatives and projects are predicted to demonstrate stronger credit strength. Moreover, the grassroots-level LGFV bonds in key regions are likely to obtain more financing and enhance their credit strength thanks to favorable policies. The result is an intensified divergence between the policy-backed LGFV bonds and those without policy support.

To obtain the full report, please call our Customer Service Hotline +852-2860 7111.

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