CCXI & CCXAP – Research & Commentary

Supply of Special Bonds May Reach Peak After Delay, and Particular Attention to Potential Risks Is Required amid Market Expansion

Hong Kong, 27 July 2021 -- A report titled "Slower-than-expected Special Bond Issues Delay the Effect of Investment Stability and Particular Attention to Potential Risks Is Required in the Context of Normalized Management: Review and Outlook of Local Government Special Bonds in H1 2021" has been recently published by the Research Institute of China Chengxin International Credit Rating Co. Ltd. ("CCXI Research Institute"). According to the Report, local government special bonds (hereinafter referred to as "special bonds"), as an important source of funds for infrastructure construction, continue to greatly fund the efforts to bolster up weak links and adjust the economic structure in the post-pandemic era. However, due to the late release of advance quotas and the increasingly tightened reviews, special bonds were issued and supplied in the first half of 2021 (H1 2021) at a pace slower than in previous years. The special bond market will be expanded faster in the second half of the year (H2 2021). Therefore, their driving force on infrastructure investment may be felt gradually in the third quarter of the year (Q3 2021). In addition, with further headway made towards the normalized management of special bonds, the efficiency of capital utilization will increase over time. The Report also reminds that it is still necessary to track the potential risks of special bonds at a time when local economies still face financial pressure prior to a full recovery.

The Report points out that due to factors such as the late release of advance quotas and the tightened project reviews, special bonds in H1 2021 were issued behind the schedule. The bonds issued only accounted for 70% of the same period last year, and tended to have obviously shorter terms. Local government bonds issued in H1 2021 totaled RMB3.34 trillion, a year-on-year decrease of RMB145.26 billion, of which special bonds were RMB1.73 trillion, a significant decrease of RMB641.72 billion year-on-year. Terms shortened year-on-year. Since new special bonds with relatively long terms were issued at a significantly slower pace, the weighted average term of special bonds shrank by 2.6 years to 12.7 years, and the bonds due in 10 years or longer accounted for nearly 70% of the total, a fall of about 20 percentage points year-on-year. From the perspective of issuance costs, the weighted average issuance rate of special bonds under a low base rebounded by 19bp to 3.52% year-on-year. The issuance rates of bonds with different terms all picked up year-on-year, but demonstrated the increased divergence, with the mid- and short-term bonds rebounding more greatly. In addition, Guangdong, Jiangsu, Zhejiang, Hebei, Beijing and other places piloted the market-based issuance of local government bonds in June. Many local government bonds overstepped the implicit limit of "up to 25bp raise from the average yield of China Government Bonds (CGBs) with the same terms five days before bidding".

The Report also indicates that refinancing bonds surged sharply year-on-year. However, new bonds grew slower than expected, and fundraising focus was placed on the existing projects, with the proportion of bonds invested in shantytown redevelopment continuing to jump. In H1 2021, RMB716.485 billion of refinancing bonds were issued, which was about 5 times that of the same period last year. The proportion of refinancing bonds in special bonds rose sharply

by 35 percentage points to 41%. Over 60% of the proceeds were used to repay the principal of maturing bonds, while the remaining were used to repay the existing government debts. New special bonds totaled RMB1.01 trillion, less than half of those in the same period last year. A figure only completed 29% of the issued quota, far lower than the level in the same period last year. From a regional perspective, the remaining 29 provinces except Shanghai and Hainan all issued special bonds. Specifically, Shandong and Guangdong issued considerable special bonds, while other eight provinces like Guizhou have not yet issued new special bonds. Under the debt repayment pressure, the 29 provinces all issued refinancing bonds, and the proportion of refinancing bonds was even higher in the regions facing great debt rolling pressure. In terms of varieties, about 80% of new special bonds were invested in the existing projects, which mainly came from such fields as municipal industrial parks, transportation, shantytown redevelopment, and people's livelihood. Of these, the proportion of special bonds going to shantytown redevelopment far exceeded the full-year amount in 2020. At the same time, the fundraising fields of special bonds got further expanded, and rural revitalization bonds were introduced as an innovative bond type. In addition, special bonds restarted the application of project capital in Q2, with the scale and quantity dropping significantly compared with the same period last year. Investment was still concentrated in the transportation field.

Looking ahead, the Report believes that special bonds will increase supply faster in H2 2021, with the bonds to be issued totaling at least RMB3 trillion. These bonds will continue to focus on key areas and major projects, thus expected to drive infrastructure investment in an increasingly obvious way in Q3. The Report forecasts the scale and pace of special bond issues in H2 2021. As of the end of June, the remaining amount of new special bonds stood at nearly RMB2.5 trillion. The issuance of such bonds may last until the end of Q4. The supply pressure is likely to rise in Q3, with the monthly average issuance volume exceeding RMB500 billion. The possibility of annual quota retention cannot be ruled out. Under the pressure of bond maturity, refinancing bonds may need to issue at least RMB0.5 trillion to repay the principal of maturing bonds. Special attention should be paid to the pressure from roll-over bonds in Q3. If the demand for repayment of existing debts in various places is taken into consideration, the issuance amount may be increased further. With respect to directions of investment, special bonds will still focus on infrastructure areas, such as the new infrastructure and new urbanization initiatives as well as major projects, the fields concerning people's livelihood, and the field of rural revitalization (coupled with the new urbanization drive as a two-wheel drive), with an aim to bolster up weak links, adjust the structure, and stabilize investment continuously. In addition, the Report estimates that theoretically, special bonds may drive investment in infrastructure worth about RMB5.2 trillion for the whole year of 2021. The driving force may gradually appear in Q3, but the actual effect is still limited by many factors such as quota occupation, field of investment, capital utilization, and project progress. So it is necessary to pay continuous attention.

In closing, the Report reminds with further headway made towards the normalized management of special bonds, the efficiency of fund utilization will increase gradually, but it is still necessary to track the potential risks of special bonds at a time when local economies still face financial pressure prior to a full recovery. For example, the further tightened reviews of special bond projects may hold back the pace of subsequent bond issuance, the annual quota for new bonds may be partially retained, and there is the possibility of adjusting the purpose of bonds to refinancing and diverting the field of invested projects to shantytown redevelopment. Under this

circumstance, it is likely for special bonds to drive infrastructure investment in a way not as good as expected. At the same time, local governments still face financial pressure in the post-pandemic era. As the peak maturity is approaching, the considerable debt service and interest payment amount may further aggravate the pressure on local finances. In addition, the special bond projects now are relatively weak in profitability. Under the huge repayment pressure, local governments may still need to rely on land transfer income or refinancing to roll over their debts. Therefore, it is necessary to be cautious about the possibility that local governments resume their old path of “land finance”. At the same time, taking into account that special bonds have fairly long rolling-over periods, it may lead to a significant increase in bond interest costs. Furthermore, there will be interest rate risks in the future. It is necessary to pay continuous attention to the uncertainty around subsequent repayments.

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