

Credit Opinion

8 February 2024

Ratings	
Senior Unsecured Debt Rating	BBB _g -
Long-Term Credit Rating	BBB _g -
Outlook	Stable
Category	Corporate
Domicile	China
Rating Type	Solicited Rating

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Shandong Luzhong Investment Co., Ltd.

Initial credit rating report

CCXAP assigns first-time long-term credit rating of BBB_g- to Shandong Luzhong Investment Co., Ltd., with stable outlook.

Summary

The BBB_g- long-term credit rating of Shandong Luzhong Investment Co., Ltd. (“SDLZ” or the “Company”) reflects Yiyuan County Government’s relatively strong capacity to provide support and its extremely high willingness to provide support based on our assessment of the Company’s characteristics.

Our assessment of Yiyuan County Government’s capacity to provide support reflects its location advantage in Zibo City with steady economic growth, but constrained by its modest fiscal profile.

The rating also reflects the local government’s willingness to provide support, which is based on the Company’s (1) important role in local economic development and infrastructure construction in Yiyuan County; and (2) good track record of receiving government payments.

However, the rating is constrained by the Company’s (1) increasing exposure to commercial activities; (2) rising investment needs that will heighten its debt leverage; and (3) moderate funding access.

The stable outlook on SDLZ’s rating reflects our expectation that the Yiyuan County Government’s capacity to provide support will remain stable, and the Company will maintain its importance in the development of Yiyuan County over the next 12 to 18 months.

Rating Drivers

- Important role in economic development and infrastructure construction in Yiyuan County
- Good track record of receiving government payments
- Increasing exposure to commercial activities
- Increasing debt burden with short-term debt pressure
- Moderate funding access

Rating Sensitivities

What could upgrade the rating?

The rating could be upgraded if (1) Yiyuan County Government's capacity to provide support strengthens; and (2) the Company's characteristics change in a way that strengthens the local government's willingness to provide support, such as improved refinancing ability.

What could downgrade the rating?

The rating could be downgraded if (1) Yiyuan County Government's capacity to provide support weakens; or (2) the Company's characteristics change in a way that weakens the local government's willingness to provide support, such as reduced strategic significance, or deteriorated debt management.

Key Indicators

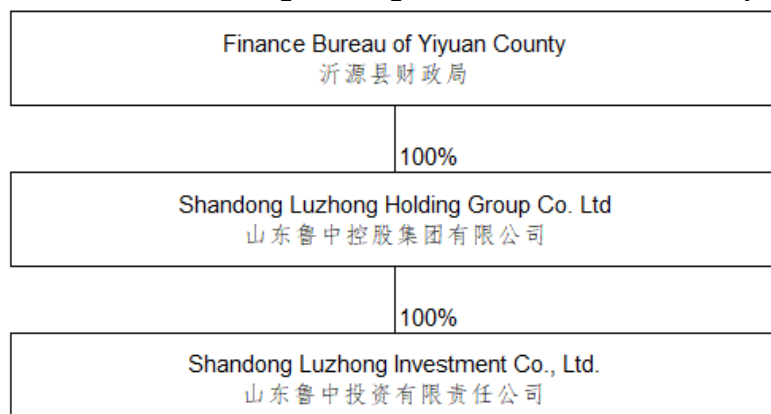
	2020FY	2021FY	2022FY	2023H1
Total Asset (RMB billion)	8.0	9.0	11.9	12.6
Total Equity (RMB billion)	4.6	5.1	7.4	7.6
Total Revenue (RMB billion)	3.7	4.1	4.5	2.5
Total Debt/Total Capital (%)	31.9	32.3	28.7	31.8

All ratios and figures are calculated using CCXAP's adjustments.

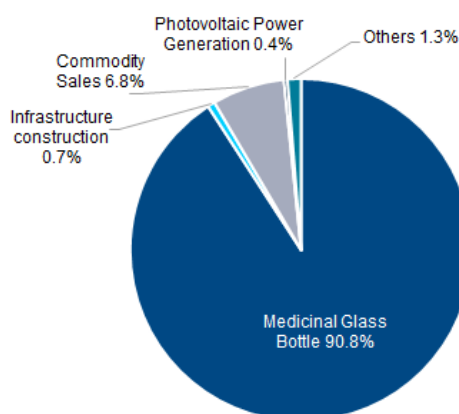
Source: Company data, CCXAP research

Corporate Profile

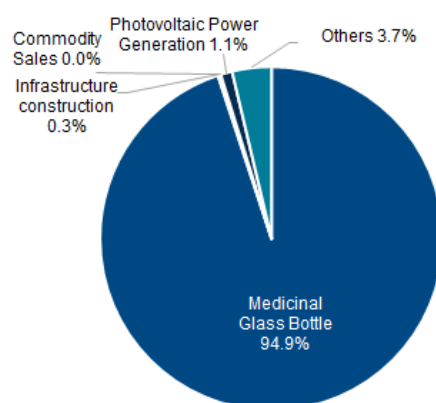
Founded in 2016, SDLZ is one of the major local state-owned enterprises that is responsible for local investment and infrastructure construction in Yiyuan County. The Company also diversified into other commercial business, including medical glass bottle sales, self-operated construction, commodity sales, and photovoltaic power generation business. SDLZ is the largest shareholder of Shandong Pharmaceutical Glass Co., Ltd ("SDPG") (Stock Code: 600529.SH), which is a leading pharmaceutical glass packaging manufacturer in China and headquarter in Yiyuan County. As of 30 September 2023, the Company was owned and controlled by the Finance Bureau of Yiyuan County ("Yiyuan Finance Bureau") through Shandong Luzhong Holding Group Co., Ltd.

Exhibit 1. Shareholding and Organization Chart as of 30 September 2023

Source: Company information, CCXAP research

Exhibit 2. Revenue Structure in 2022

Source: Company information, CCXAP research

Exhibit 3. Gross Profit Structure in 2022**Rating Considerations****Government's Capacity to Provide Support**

We believe Yiyuan County Government has a relatively strong capacity to provide support given its location advantage in Zibo City with steady economic growth, but constrained by its modest fiscal profile.

Shandong Province is the third largest province in terms of gross regional product ("GRP") in China over the past three years, with a solid industrial foundation in logistics, shipbuilding and marine technology, chemical, automotive and agri-food. Zibo City is located in the central part of Shandong Province, which is one of the core cities of Shandong Peninsula Urban Agglomeration and a regional central city in Shandong Province approved by the State Council. Zibo City recorded a GRP of RMB440.3 billion in 2022, ranking 7th by GRP among 16 prefecture-level cities in Shandong Province over the past three years. Zibo City has strong relatively fiscal strength and a manageable debt profile. In 2022, its general budgetary revenue covered around 70% of its general budgetary expenditure, and tax incomes accounted for nearly 65% of its general budgetary revenue. As of end-2022, Zibo City's government debt balance was RMB108.0 billion, accounting for 24.5% of GRP. In the first three quarters of 2023, Zibo City's GRP was RMB345.4 billion, a year-over-year ("YoY") increase of 5.2%. At the same time, it reported a general budgetary revenue of RMB30.2 billion, a YoY increase of 8.0%.

Exhibit 4. Key Economic and Fiscal Indicators of Zibo City

	2020FY	2021FY	2022FY
GRP (RMB billion)	367.4	420.1	440.3
GRP Growth (%)	2.5	9.4	4.7
General Budgetary Revenue (RMB billion)	32.2	36.9	37.6
General Budgetary Expenditure (RMB billion)	52.3	52.3	52.6
Local Government Debt (RMB billion)	77.5	94.6	108.0

Source: Statistics Bureau of Zibo City, CCXAP research

Yiyuan County is a county-level city under the jurisdiction of Zibo City, and is located in the middle of Shandong Province, with a total area of 1,636 square kilometers. With years of development, Yiyuan County has formed three core industries, including new medicine, new materials, electronic information industries; more than 100 large enterprises have settled in Yiyuan County. It has demonstrated stable economic growth in recent years. In 2022, the GRP of Yiyuan County increased to RMB32.9 billion, representing a YoY increase of 7.3%. Yiyuan County had a modest financial profile. It reported a general public budget revenue of RMB2.2 billion in 2022. The tax revenue is decreasing over the past two years and was recorded at RMB1.3 billion in 2022, accounting for 57.9% of the general budgetary revenue. In addition, Yiyuan County has a relatively weak self-sufficiency, with fiscal balance ratios (general budgetary revenue/general budgetary expenditure) of around 50% over the past three years. As of end-2022, Yiyuan County's government debt balance was RMB5.9 billion, accounting for 18% of GRP. In the first three quarters of 2023, Yiyuan County reported a general budgetary revenue of RMB1.7 billion, representing a YoY increase of 7.6%.

Exhibit 5. Key Economic and Fiscal Indicators of the Yiyuan County Government

	2020FY	2021FY	2022FY
GRP (RMB billion)	27.0	31.6	32.9
GRP Growth (%)	4.1	12.1	7.3
General Budgetary Revenue (RMB billion)	2.0	2.2	2.2
General Budgetary Expenditure (RMB billion)	4.0	4.5	4.4
Local Government Debt (RMB billion)	3.9	4.8	5.9

Source: Statistics Bureau of Yiyuan County, CCXAP research

Government's Willingness to Provide Support**Important role in the economic development and infrastructure construction of Yiyuan County**

SDLZ is one of the major local state-owned enterprises in Yiyuan County and undertakes local infrastructure construction and industrial investments in Yiyuan County. SDLZ's infrastructure projects are crucial to local social and economic development that benefits the general public and local employment. We believe that the Company will maintain an important position in the public policy projects in Yiyuan County and will not be easily replaced by other local state-owned enterprises in the foreseeable future.

The Company undertakes infrastructure construction through agency construction model. SDLZ signed construction agreements with Yiyuan Finance Bureau and will receive payments based on the total cost plus a certain markup in return during the construction progress or after the project is completed. As of 30 June 2023, the Company had 3 projects under construction, including the construction of roads, rural housing renovation, industrial park greening, drainage, and lighting, with a total invested amount of around RMB2.0 billion and

uninvested amount of RMB99 million. The Company's future construction projects under planning will be constructed under self-construction mode.

Increasing exposure to commercial business activities

SDLZ participates in different commercial activities, including medical glass bottle sales and commodity sales business. While the commercial activities generate supplemental income, they may also pose higher operational and business risks than its public-policy businesses. We consider that the Company's risk exposure to commercial activities is low but rising as SDLZ is increasing its investment in self-operated projects.

SDLZ's listed subsidiary, SDPG (Stock Code: 600529.SH), is responsible for the Company's medical glass bottles sales business. SDPG engages in the research, development, production and sales of various medicinal glass bottle products. SDPG has six major products, which are used in the packaging of various types of medicines, health products, and cosmetics products. SDPG mainly adopts demand-on-production mode for the medical glass bottles sales business, and the products are sold to large domestic and overseas customers, such as Qilu Pharmaceutical Co., Ltd., Yangze River Pharmaceutical (Group) Co., Ltd., and Bayer Healthcare Limited. The revenue from this business sector increased from RMB3.4 billion in 2020 to RMB4.1 billion in 2022, which has contributed considerable amount of income to the Company. Meanwhile, the Company also receives share dividends from SDPG every year. However, affected by the rising costs in raw materials such as coal and soda ash, and increasing shipping and freight fees caused by COVID-19 pandemic situation, the gross profit margin of this business decreased from 33.2% in 2020 to 26.12% in 2022. As of 30 June 2023, SDPG had 3 key projects under construction, which are expected to further increase the Company's production capability in the future.

SDLZ also had some self-operated construction projects. As of 30 June 2023, the Company had 2 industrial park construction projects under planning, including factory building, office buildings, and parking lots, with a total investment of RMB3.1 billion. The Company is expected to achieve fund balancing through future operating income, such as leasing income. However, the investment recovery cycle is long, making it more difficult to achieve fund balancing in short period of time. Meanwhile, the relatively large scale of investment will bring more pressure on the capital expenditure of the Company.

SDLZ also engages in commodity sales business, and the main product is ethylene. The Company only sell the products to downstream customers when receiving full payment. However, the concentration risk from upstream and downstream customers are high, with only one upstream supplier and one downstream customer, which are state-owned enterprises in Yiyuan County. Moreover, the gross profit of this business sector generated by the Company is low. There is an uncertainty in the future earnings of the Company's commodity sales business.

Good track record of receiving government payments

SDLZ has a proven track record of receiving support from the local government in terms of capital injections, project payment, and subsidies. In 2019, the local government transferred its shareholdings of SDPG to the Company, diversifying the business scope of the Company. The Company also received capital injection of RMB300 million in cash, enhancing the capital strength of the Company. In addition, SDLZ also has a good track record of receiving government payments. From 2020 to 2022, SDLZ continuously received government subsidies with a total amount of around RMB250.4 million, including fiscal and operating subsidies, which support its future investments and debt repayments. As of 30 June 2023, SDLZ has received total project payments of about RMB100 million from the local government for its infrastructure construction projects. We expect that, as the key local state-owned enterprise in Yiyuan County, the Company plays an irreplaceable role

in the development and operation of the region, and will continue to receive government support over the next 12 to 18 months.

Increasing debt burden with short-term debt pressure

Due to the continuous investment in infrastructure construction projects, SDLZ's total debt has been growing over the past three years. As of 30 June 2023, the Company's total debt increased to RMB3.5 billion from RMB2.1 billion as of end-2020. The Company has maintained moderate debt leverage. Its total capitalization ratio, as measured by total debt to total capital, was recorded at 31.1% as of the same date. However, the Company is exposed to certain short-term debt repayment pressure. As of 30 June 2023, its short-term debt was RMB2.3 billion, accounting for around 67% of total debt. Meanwhile, after excluding restricted cash, the cash to short-term debt ratio was 0.3x, indicating that its cash reserve could not fully cover the short-term debt. Given the Company's future capital expenditure pressure for its investment and construction projects, we expect the Company's debt level will continue to increase for the next 12-18 months.

Moderate funding access

SDLZ had access to various sources of funding, including bank loans, onshore and offshore bond financing and non-standard financing. The Company maintains long-term relationships with several banks, such as Agricultural Development Bank of China and China Bohai Bank Co., Ltd. However, the funding sources of the Company were mainly from regional banks in Shandong Province. As of 30 June 2023, the Company had total bank credit facilities of RMB2.8 billion, with an unutilized portion of RMB822 million, indicating insufficient credit facilities. Moreover, the Company's financing also relies on stock pledged loans and loans obtained through guarantees from other state-owned enterprises.

The Company also has a good track record for fund-raising activities in capital market. From 2020 to January 2024, the Company issued 3 tranches of onshore bonds, including private placement notes and corporate bond, raising RMB1.5 billion. It also has an access to offshore bond market. In June 2023, SDLZ issued one tranche of offshore bond, raising RMB185 million. As of 30 June 2023, the Company's exposure to non-standard financing is manageable, accounting for less than 20% of total debt. However, these types of financing generally have high financing cost and short-term borrowing period, which may enlarge SDLZ' refinancing pressure.

Medium exposure to contingent risk

The Company bears moderate contingent risk resulting from relatively large external guarantees, which could potentially increase its repayment obligations. As of 30 June 2023, the Company's external guarantees amounted to RMB959 million, accounting for 12.7% of its net assets. All the external guarantees were provided to other local state-owned enterprises, such as, Shandong Luzhong Hi-tech Park Development Co., Ltd. and Yiyuan Hongrui Asset Management Co., Ltd. We believe that the credit risk of the guarantee is moderately controllable, taking into account the government's support to local state-owned enterprises.

ESG Considerations

SDLZ assumes environmental risks through its infrastructure construction projects. Such risks could be moderated through environmental studies and detailed planning prior to the start of the projects and close supervision during construction.

SDLZ bears social risks as it implements public policy initiatives by building public infrastructure in Yiyuan County. Demographic changes, public awareness and social priorities shape the Company's development targets and ultimately affect the local government's propensity to support the Company.

SDLZ's governance considerations are also material as the Company is subject to oversight by Liyang County Government and has to meet several reporting requirements, reflecting its public-policy role and status as a government-owned entity.

Structural considerations

SDLZ's senior unsecured debt rating is equal to its long-term credit rating. We believe that government support will flow through the Company given its important role in economic development and infrastructure construction in Yiyuan County, thereby mitigating any differences in an expected loss that could result from structural subordination.

Rating Methodology

The methodology used in this rating is the Rating Methodology for [China's Local Infrastructure Investment and Financing Companies \(July 2022\)](#).

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