

Credit Opinion

29 August 2023

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

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Heze Urban Construction Engineering Development Group Co., Ltd.

Initial credit rating report

CCXAP assigns first-time long-term credit rating of BBB_g to Heze Urban Construction Engineering Development Group Co., Ltd., with stable outlook.

Summary

The BBB_g long-term credit rating of Heze Urban Construction Engineering Development Group Co., Ltd. (“HUCG” or the “Company”) reflects the Heze Municipal Government’s (1) strong capacity to provide support, and (2) very high willingness to provide support based on our assessment of the Company’s characteristics.

Our assessment of Heze Municipal Government’s capacity to provide support reflects Heze City’s increasing economic strength and moderate fiscal metrics.

The rating also reflects the local government’s willingness to provide support, based on the Company’s (1) status as an important infrastructure construction entity with a strong market position in Heze City; and (2) good track record of receiving government support.

However, the rating is constrained by the Company’s (1) medium exposure to commercial activities; (2) large refinancing needs; and (3) medium contingent liabilities risk from external guarantees to local state-owned enterprises.

The stable outlook on HUCG’s rating reflects our expectation that the local government’s capacity to provide support will remain stable, and the Company will maintain its important role in infrastructure construction of Heze City over the next 12-18 months.

Rating Drivers

- Important infrastructure construction entity with a strong market position in Heze City
- Providing essential public services
- Good track record of receiving government support
- Medium exposure to commercial activities
- Large refinancing needs albeit reduced debt burden
- Medium contingent liabilities risk from external guarantees to local state-owned enterprises

Rating Sensitivities

What could upgrade the rating?

The rating could be upgraded if (1) the Heze Municipal Government's capacity to support strengthens; and (2) the Company's characteristics change in a way that enhances the local government's willingness to support, such as increased strategic significance, diversified financing channels, and improved liquidity position.

What could downgrade the rating?

The rating could be downgraded if (1) the Heze Municipal Government's capacity to support weakens; or (2) the Company's characteristics change in a way that weakens the local government's willingness to support, such as reduced strategic significance, materially increased exposure to risky commercial activities, or decreased government payments.

Key Indicators

	2020FY	2021FY	2022FY
Total Asset (RMB billion)	20.7	23.3	26.6
Total Equity (RMB billion)	3.2	8.9	9.3
Total Revenue (RMB billion)	3.6	3.4	4.7
Total Debt/Total Capital (%)	69.7	47.1	42.2

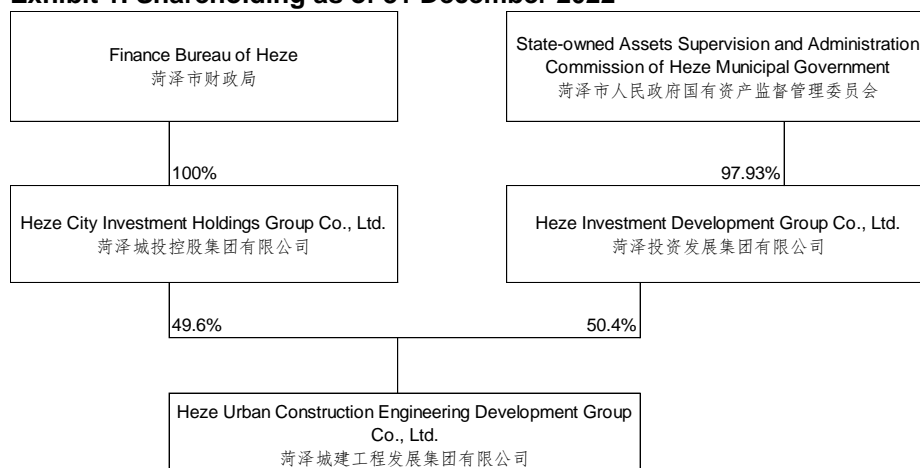
All ratios and figures are calculated using CCXAP's adjustments.

Source: Company information, CCXAP research

Corporate Profile

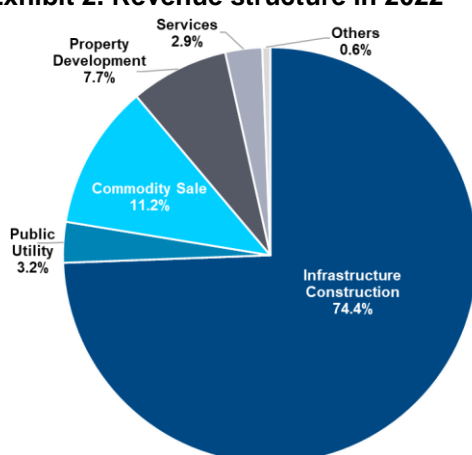
Founded in 2009, HUCG is one of the key local infrastructure investment and financing company ("LIIFC") in Heze City and the core subsidiary of Heze Investment Development Group Co., Ltd. ("HZID"). HUCG is primarily responsible for infrastructure construction, heat supply, and steam supply. It also participates in different commercial activities such as property development, self-operated project construction, commodity sales, and manufacturing. As of 31 December 2022, HZID and Heze City Investment Holdings Group Co., Ltd. held 50.4% and 49.6% shares of the Company respectively, and the Heze Municipal Government was the ultimate controller.

Exhibit 1. Shareholding as of 31 December 2022



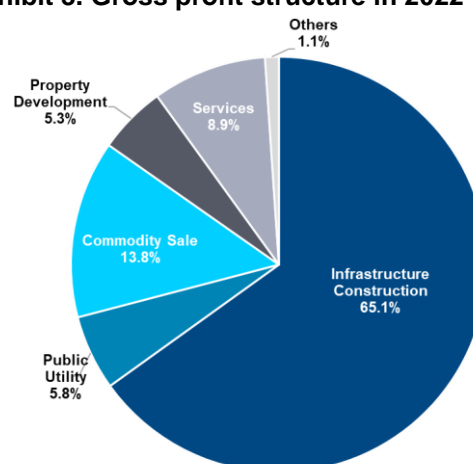
Source: Company information, CCXAP research

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 the local government of Heze City has a strong capacity to provide support given its sound economic fundamentals, with increasing economic strength and moderate fiscal metrics.

Shandong is the third largest province in China by gross regional products ("GRP"), with a solid foundation in different industries such as logistics, shipbuilding, marine technology, chemical, automotive, and agri-food. Heze City is a prefecture-level city of Shandong Province and is located in the southwest of Shandong Province with a good economic foundation. Heze City's GRP ranked 8th among 16 prefecture-level cities in Shandong Province over the past three years. Heze City's economic growth is mainly driven by the key industries including the high-end chemical industry, biomedicine, mechanical and electrical equipment manufacturing, new energy and new material, agricultural and sideline products, as well as trade logistics and e-commerce.

In 2022, Heze City reported a GRP of RMB420.5 billion, recoding an economic growth of 4.2% year-over-year ("YoY"). Its fiscal balance was modest, with a general budgetary revenue to general budgetary expenditure ratio of 44.3%, and tax accounted for 66.7% of the general budgetary revenue. However, the government fund

income dropped by RMB11.2 billion to RMB36.1 billion in 2022 due to the reduction of state-owned land use rights transfer. This income is mainly affected by regulatory policies and the land market, we expect the downturn of the real estate industry may lead to a decrease in following years. As of 31 December 2022, Heze Municipal Government reported an outstanding government debt of RMB131.2 billion and accounted for 31.2% of its GRP, increased from that of RMB110.8 billion and 27.9% as of 31 December 2021.

Exhibit 4. Key economic and fiscal indicators of Heze City

	2020FY	2021FY	2022FY
GRP (RMB billion)	348.3	397.7	420.5
GRP Growth (%)	3.9	8.8	4.2
General Budgetary Revenue (RMB billion)	23.8	28.4	29.0
General Budgetary Expenditure (RMB billion)	63.0	63.3	65.4
Local Government Debt (RMB billion)	86.8	110.8	131.2

Source: Statistics Bureau of Heze City, CCXAP research

Government's Willingness to Provide Support

Important infrastructure construction entity with a strong market position in Heze City

HZID the largest LIIFC in Heze City in terms of asset size, which is primarily responsible for public activities. HUCG is the key subsidiary of HZID and conducts the majority of its businesses. Since its establishment, the Company has played an important role in the implementation of infrastructure construction and has completed major infrastructure projects, demonstrating a strong market position.

HUCG carries out various infrastructure construction projects mainly through the engineering construction model, agent construction model, and public-private partnership ("PPP") model. Under the agent construction model, the Company signs an agreement with the entrusting party Heze Economic Development Zone Management Committee, and the entrusting party pays based on the construction cost plus an agreed rate of return, generally around 8%, after examination of the completion of construction projects. As of 31 December 2022, there were 3 resettlement housing projects under construction, with a planned investment of RMB4.9 billion and an uninvested amount of RMB762 million.

Under the engineering construction model, HUCG mainly undertakes the shantytown renovation, resettlement housing, and municipal engineering projects in Heze City with relevant qualifications. Thanks to its state-owned background, the Company newly acquired 23 high-quality contracts with total contracted amount of RMB4.6 billion in 2022. As of 31 December 2022, the Company's top five engineering construction projects under construction had a planned investment of RMB6.5 billion and an uninvested amount of RMB2.6 billion, respectively. The sufficient project reserves ensure the sustainability of the Company's infrastructure construction business. Also, the payment of the projects is paid according to the progress and some projects are supported by special funds, which partially release the Company's investment pressure.

Under the PPP model, HUCG has entered into the "Shan County Jiashan Xindu Comprehensive Development PPP Project Contract" and held 85.0% equity of project company as social capital. According to the PPP contract, the Company was responsible for the construction and operation of the National Fitness Center, Roads, Shan County Art Exchange Center, Primary School, and Science and Technology Museum. Among them, the community elderly care medical center and kindergarten have been transferred to other parties for further construction. Therefore, the Company will no longer participate in the construction and additional investment, and other projects have been completed and entered the operation stage. The fund balancing of

the PPP project is expected to be achieved through “viability gap funding” provided by the Shan County Government and operating income within the operation period of 10 years. Currently, the payment of PPP projects was slow and the received amount was RMB57 million as of 31 December 2022.

Providing essential public services in Heze City

HUCG provides essential public services in Heze City such as heat supply and steam supply. The Company's subsidiary started its steam supply business in 2020, covering the northern urban area of Heze City. As 31 December of 2022, the Company owned a pipe network length of around 39 kilometers, providing centralized heat and steam supply services to 14 communities and 28 steam users in Heze City. Moreover, the Company conducts heat supply in a small number of areas in Heze City with 97 kilometers of heating pipelines, covering more than 3,000 residential users. The Company's strategic role in the provision of public services will be strengthened as its heat supply and steam supply businesses continue to expand. As of 31 December 2022, HUCG had 2 key projects in the public utility segment under construction, with total investments and uninvested amounts of RMB1.2 billion and RMB567 million, respectively. Given the public welfare nature of heat supply business, the profitability is relatively low. However, the steam supply business is targeted at industrial enterprises and parks, with stronger profitability.

Good track record of receiving government support

HUCG has a good track record of receiving support from the Heze Municipal government in terms of subsidies, capital injection, special funds, and equity transfer. In 2021, the local government allocated special funds as national capital investment, which significantly increased the Company's capital reserves of RMB5.4 billion. In 2022, the local government also transferred RMB499.2 million from Company's capital reserves to paid-in capital. As of 31 December 2022, the paid-in capital and capital reserves of HUCG increased to RMB600 million and RMB6.2 billion, respectively, demonstrating enhanced capital strength. Moreover, from 2020 to 2022, the local government consistently provided approximately RMB37.0 million in subsidies for the Company, supporting its operation of public businesses. Furthermore, the Company received special bonds of RMB600 million to support its construction projects and operation. Given the strategically important role of the Company in Heze City and the essential subsidiary of HZID, we believe that HUCG will continue to receive different kinds of support from the local government.

Medium exposure to commercial activities

HUCG's exposure to commercial activities is medium as the commercial assets accounted for between 20% and 30% of total asset as of 31 December 2022. Apart from the public policy activities, the Company also participates in different commercial activities consisting of property development, self-operated project construction, commodity sales, and manufacturing.

HUCG's property development business mainly involves the construction and sales of residential properties in Heze City. As of 31 December 2022, the Company had 3 projects under construction including commercial housing and office buildings, with a total investment of RMB3.2 billion and an uninvested amount of RMB801 million. Meanwhile, the Company had no land reserves for property development and subsequent planned development projects. Therefore, the exposure to the property development segment that we consider to be lower in the short to medium term. However, during the downturns in China's property market, construction projects would be exposed to more uncertainties during construction, sales, and operation.

At present, HUCG focuses on the construction of self-operated projects, including industrial parks, vocational education centers, and economic parks. The construction costs of such self-operated projects will be balanced by the operating income generated after the construction is completed. However, relatively high pressure on capital expenditure is arising from construction projects. As of 31 December 2022, the Company had several self-operate projects under construction, with a total estimated investment of RMB4.3 billion, and an uninvested amount of RMB1.0 billion.

HUCG also engages in the commodity trading business, with diversified trading products such as supply chains and building materials. However, the top 5 customers and suppliers of building materials trading business represented 61.5% and 53.5% of the purchase amount and sales amount in 2022, demonstrating relatively high concentration risk. In addition, the Company participates in manufacturing businesses such as building material production, bringing supplemental income to the Company. However, the manufacturing business is easily influenced by the economic conditions and industry cycles, with a certain degree of volatility. These market-driven businesses may also pose higher operating and business risks to the Company compared with its public-policy businesses, in our view.

Large refinancing needs albeit reduced debt burden

HUCG's total debt decreased from RMB7.5 billion as of 31 December 2020 to RMB6.8 billion as of 31 December 2022, while the capitalization ratio decreased from 69.7% to 42.2% over the same period, mainly due to the change in accounting recognition of several tranches of interest-bearing debt. However, HUCG had relatively weak liquidity profile with large proportion of short-term debts. As of 31 December 2022, the Company's short-term debt was RMB4.4 billion, accounting for 65.2% of its total debt. The Company held cash and cash equivalents of RMB2.5 billion, which was approximately 0.6x of its short-term debt, indicating large refinancing pressure in 2023.

Fortunately, bank loans accounted for more than 70% of interest-bearing debt over the same period, such refinancing risk could be mitigated by its relatively sufficient standby liquidity. As of 31 December 2022, the Company had total bank facilities of RMB5.9 billion, with the available portion being RMB2.2 billion. Moreover, the non-standard financing accounted for less than 10% of total debt which we consider to be a reasonable level. Benefiting from large proportion of bank loans with lower cost, the weighted average financing cost of HUCG was less than 5.0%.

Due to the large capital expenditure of construction projects and the large amount of debt maturities, we estimate the Company would continue to rely on external financing and mainly on bank loans. As a result, its debt burden would moderately increase over the next 12-18 months.

Medium contingent liabilities risk from external guarantees to local state-owned enterprises

HUCG bears moderate contingent risk resulting from large external guarantees to local state-owned enterprises ("SOEs"). As of 31 December 2022, the Company's external guarantees amounted to RMB2.4 billion, accounting for 26.2% of its net assets. In case a credit event occurs, the Company may face certain contingent liability risks. We believe that most of these local SOEs are likely to be supported by the local government when necessary due to the nature of the enterprises, therefore contingent risk would be controllable.

ESG Considerations

HUCG is exposed to environmental risks due to undertaking key infrastructure construction. Such risks could be moderated by conducting environmental studies and planning prior to the start of the projects, and close monitoring during the construction phase.

The Company bears social risks as it implements public policy initiatives by playing an important role in the social welfare of Heze City. 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.

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

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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