**Credit Opinion** 13 June 2018

# Dezhou Deda City Construction Investment Operation Co., Ltd.

Hong Kong

| | |
|---|---|
| Category: | Corporate Rating |
| Rating Type: | Solicited Rating |
| Industry: | Local Government Financing Vehicles |
| Long-term Credit Rating: | $BBB_g$+ |
| Rating Outlook: | Stable |


Analysts:

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|---|---|
| Elle Hu | elle_hu@ccxap.com |
| Jacky Lau | jacky_lau@ccxap.com |

Director of Credit Ratings:

| | |
|---|---|
| Guo Zhang | guo_zhang@ccxap.com |

Tel.: +852-2860 7111


## Key Indicators

| Dezhou Deda City Construction Investment Operation Co., Ltd. [1] | 2017 | 2016 | 2015 |
|---|---|---|---|
| Total Assets (RMB million) | 44,018.9 | 48,522.4 | 46,691.0 |
| Total Assets (USD million) [2] | 6,736.7 | 6,994.7 | 7,190.3 |
| Net Assets (RMB million) | 19,384.3 | 22,039.8 | 21,543.5 |
| Net Assets (USD million) [2] | 2,966.6 | 3,177.1 | 3,317.6 |
| Total Revenue (RMB million) | 5,000.2 | 4,455.9 | 2,976.9 |
| Total Revenue (USD million) [2] | 765.2 | 642.3 | 458.4 |
| Net Profit (RMB million) | 370.1 | 416.2 | 181.8 |
| Net Profit (USD million) [2] | 56.6 | 60.0 | 28.0 |
| Gross Margin (%) | 10.8 | 19.9 | 21.5 |
| Return on Equity (%) | 1.8 | 1.9 | 0.9 |
| Total Debt / Total Capital (%) | 28.9 | 35.3 | 32.3 |
| Net Gearing Ratio (%) | 30.4 | 46.3 | 40.6 |
| Total Debt / EBITDA (x) | 8.2 | 19.0 | 21.7 |
| EBITDA / Interest (x) | 2.3 | 1.3 | 0.7 |

[1] Consolidated financial statements in accordance with PRC GAAP audited by Reanda Certified Public Accountants LLP.
[2] Exchange rates for 2014 (1 USD = 6.1190 CNY), 2015 (1 USD = 6.4936 CNY), 2016 (1 USD = 6.9370 CNY), and 2017 (1 USD = 6.5342 CNY) announced by PBOC
Source: Company data, CCXAP research

## Rating Drivers

- Proven on-going high level of support from shareholders
- Modest capital investments plan in primary land development due to destocking of inventories in the years to come
- Manageable capital investments in infrastructure construction segment due to change in operational model
- High vulnerability to cyclicity of real estate market with narrowing profitability
- Moderate credit metrics and solid liquidity position

## Rating Rationale

The $BBB_g$+ rating of Dezhou Deda City Construction Investment Operation Co., Ltd. ("DDCCIO" or the "Company") is underpinned by (1) high level of support from shareholders given its strategic position; (2) moderate credit metrics; and (3) solid liquidity position. However, the rating is also constrained by the Company's (1) narrowing profitability metrics; (2) vulnerability to cyclicity of real estate market.

## Rating Outlook

The stable outlook on DDCCIO's rating reflects its strategic position of primary land development and infrastructure construction in Dezhou City with high level of support from its shareholders. We expect that the Company will maintain its strategically important position to Dezhou City and further develop as an important entity for city construction, utility services and property development in Dezhou City.

**What could upgrade the rating?**

The rating could be upgraded if (1) the Company would be granted with more favorable policy and financial support; (2) the Company improves its profitability and credit metrics.

**What could downgrade the rating?**

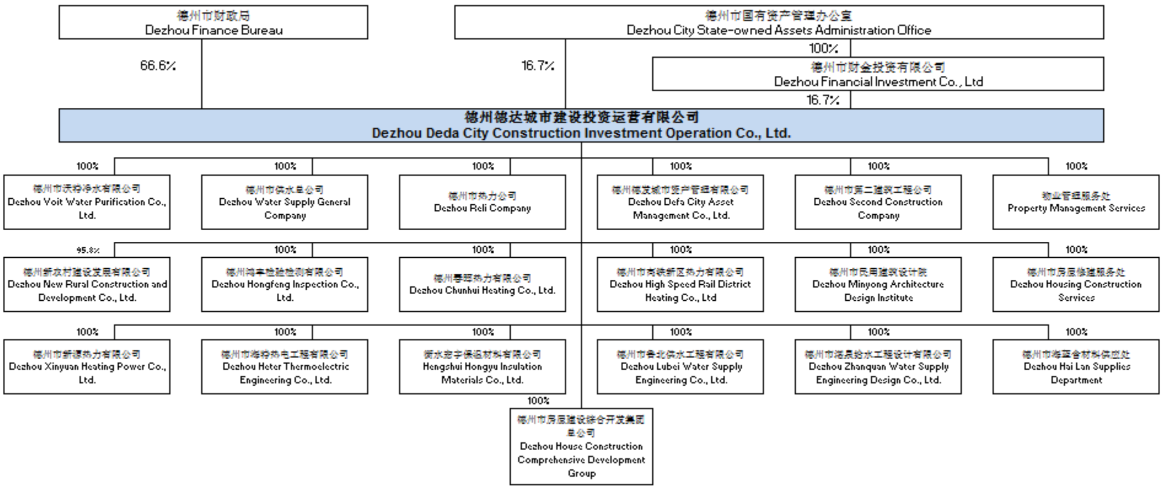
The rating could be downgraded if (1) there is reduced support from shareholders; (2) the Company records substantially weakening credit metrics in the future; (3) there are substantial constraints on the Company's refinancing capability.

## Corporate Profile

Founded in October 2006, the Company was established by Dezhou Finance Bureau with registered capital of RMB 300.0 million and was formerly known as Dezhou Defa City Construction Investment Co., Ltd. In July 2009, the Company merged with the original Dezhou Deda City Construction Investment Operation Co., Ltd. and changed its name to DDCCIO. As of 31 December 2017, Dezhou Finance Bureau held 66.6% of the Company's shares and was the ultimate controlling shareholder of the Company. DDCCIO has a strategically important position in Dezhou City, and is principally engaged in primary land development, city construction, property development and provision of utility services.

As at end-2017, DDCCIO reported consolidated total assets and total equity of RMB 44,018.9 million and RMB 19,384.3 million, respectively. In 2017, the Company generated revenue of RMB 5,000.2 million and net profit of RMB 370.1 million.

**Exhibit 1. Shareholding and Organization Chart as of 31 December 2017**




Source: Company information

## Detailed Rating Considerations

### 1. Proven high level of on-going support from shareholders

Dezhou City is a prefectural-level city in Shandong Province. Dezhou City demonstrated stable economic growth in recent years, but its economic strength was at relatively weak position in Shandong Province, ranking No.11 among the 17 prefectural-level cities in terms of 2017 GDP. In 2017, Dezhou City recorded preliminary GDP of RMB 329.6 billion, indicating a YoY growth of 7.5%. GDP growth was mainly driven by tertiary industries which increased by 8.6% YoY, as compared to the YoY growth of 3.6% in primary industries and 6.9% in secondary industries. Primary, secondary and tertiary industries accounted for 9.7%, 47.3% and 43% of GDP in 2017, suggesting improvement in economic structure.

**Exhibit 2. Dezhou City's GDP and Growth**

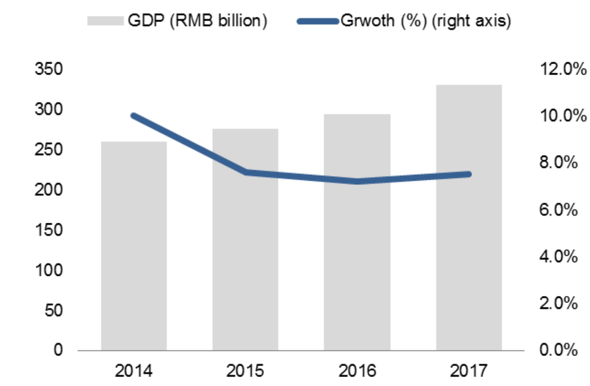
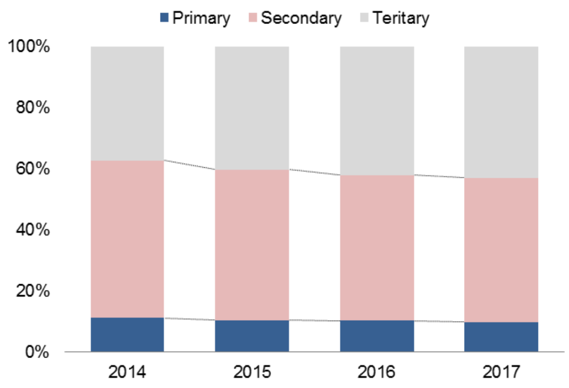



**Exhibit 3. Dezhou City's GDP Structure**




Source: Dezhou Finance Bureau, CCXAP research

As an important entity for primary land development and infrastructure construction of Dezhou City, the Company received on-going high level of support from its shareholders given its strategically important role. The shareholders have a track record of providing financial support to DDCCIO in the form of asset injection, financial subsidies, and debt swap programme.

| (RMB million) | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|---|
| Asset injection | - | 0.1 | 360.5 | 476.8 | 8,577.6 | 1,690.1 | 1,922.1 |
| Financial subsidies | 422.5 | 9.6 | 46.1 | 36.8 | 44.5 | 133.0 | - |
| Debt swap | 7,145.0 | 4,533.0 | 10,979.0 | - | - | - | - |

**Exhibit 4. Financial support from shareholders in 2011-2017**

Source: Company data, CCXAP research

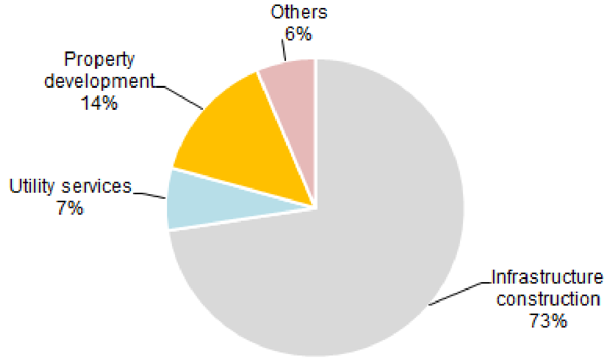
The Company's shareholders have injected assets of a total amount of RMB 13,027.2 million to the Company since 2011. The Company received financial subsidies mainly including resettlement subsidies and heating subsidies from Dezhou Municipal Government since 2012. Furthermore, the Company's debt of RMB 22,657 million was recognized as local government debt during 2015, all of which has been swapped by end-2017.

We anticipated that the Company's shareholders will continue to provide strong support to DDCCIO due to its strategic position for Dezhou City.

## 2. Modest capital investments plan in primary land development due to destocking of inventories in the years to come

DDCCIO mainly undertakes the role of primary land development, infrastructure construction, property development, and utility services such as heating and water supply in Dezhou City. Its major service areas include Decheng District, the Economic and Technological Development Zone and the Canal Development Zone. In 2017, infrastructure development contributed 72.6% of total revenue of the year, while property development contributed 14.3% of total revenue. Primary land development recorded zero contribution due to no land sales in 2017, as compared to 15.9% of total revenue in 2016.

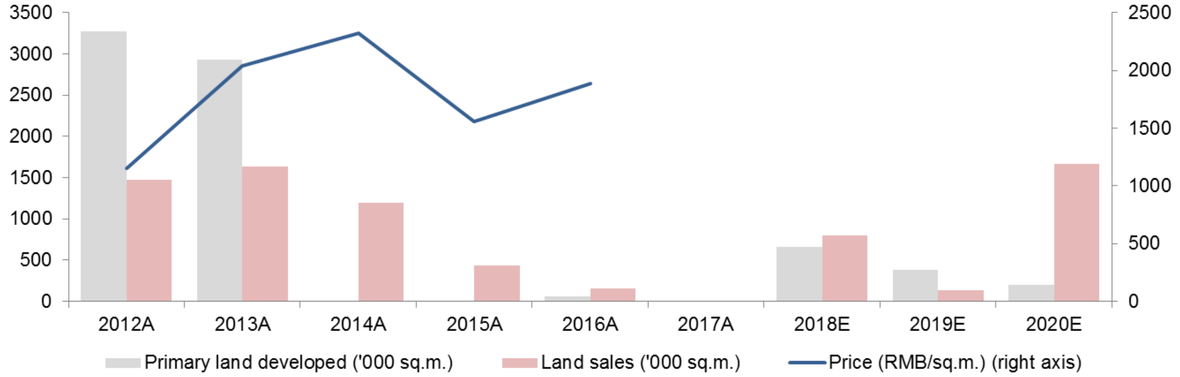
**Exhibit 5. The Company's Revenue Composition in FY2017**




Source: Company data, CCXAP research

The Company currently operates primary land development under government procurement model, qualified for single-source procurement arrangement. Prior to 2017, the Company used to get all the land sales proceeds net of taxes. As for the new government procurement model, after the Company finishes primary land development, the Bureau of Land and Resources would put the land parcels in auction market and the Company would receive development cost plus 10%-15% of land sales proceeds as agreed in the service contract. CCXAP expects potential decline in the Company's profitability of primary land development segment as compared to historical gross profit margin of around 50%.

**Exhibit 6: Summary of primary land developed and sold in 2012A-2020E**




Source: Company data, CCXAP research

The Company has completed large volume of primary land development in prior years. Dezhou's land market showed reduced land supplies and rising land prices in recent years. The land prices experienced a tumble in 2015 after major boom, and started to pick up rising momentum in 2017. With the relatively large primary land reserves in Dezhou City, the local government is going to gradually accelerate land supplies in 2018, with actual land sales still subject to uncertainties. CCXAP expects that DDCCIO would slow down its capital investment in primary land development segment with future revenue mainly deriving from its land inventories that has been developed in prior years.

### 3. Manageable capital investments in infrastructure construction segment due to change in operational model

In terms of infrastructure construction, DDCCIO used to operate under BT model such that it generally charged 8%-15% markup on construction cost. Starting from mid-2017, most of the major infrastructure construction projects would be operated under Public-Private Partnership ("PPP") model while DDCCIO can act as either governmental entity or private party.

According to the Company's preliminary three-year capital investment schedule, more than 50% of future capital expenditure would be carried out under PPP model in the years to come. As at end-2017, the Company had one key PPP project under planning, which was "The Convention Center" in the preliminary preparation stage.

DDCCIO would form a project company under the PPP arrangement. To be qualified as recognized PPP, the projects should have proposals passing multiple stages of approval including the Value for Money and Fiscal Capacity Assessment. Should the projects be recognized as PPP, the project company could obtain low-cost funding from government sponsored entities and the local government would include annual financial subsidies to the project (if any) in fiscal budget, which would help ensure the certainty of project cash flows.

However, project screening and assessment could be time consuming and whether the projects could be recognized as PPP projects is subject to many uncertainties. Considering PPP model under increasingly tightening regulations since late 2017, CCXAP would closely monitor the progress of the Company's PPP projects and potential impact on its future cash flows.

The Company also takes up projects other than PPP projects, which include infrastructure construction and investment projects as well as small-scale construction projects. For infrastructure construction and investment projects, the Company would earn operational income from the project after completion. As at end-2017, the Company has one project under planning with estimated investment amount of around RMB 660.0 million. For small-scale construction projects, the local government would pay the Company in the form of revenue subsidies, but there might be some delay in cash inflows and investment returns. As at end-2017, the Company has several projects under planning to be completed in 2018 with gross investment of over RMB 1,289.0 million.

As the majority of infrastructure projects would be carried out as PPP projects in the future, CCXAP expects that most of the proceeds from infrastructure investment would be realized as investment income from project companies and recurring revenue from infrastructure operation. In the meanwhile, the Company will recognize revenue from infrastructure construction with completion of existing projects in the next 1-2 years.

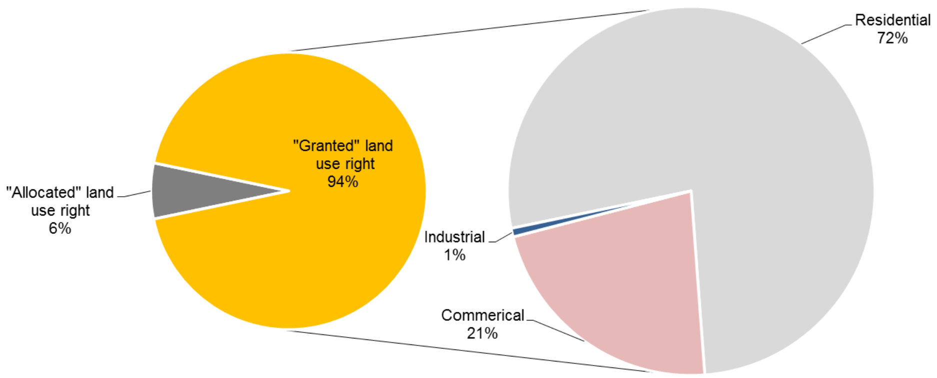
## 4. Expansion in property development business with sufficient land bank, but high vulnerability to cyclicity of real estate market

DDCCIO is engaged in development of resettlement housing, residential properties, and urban complex projects. The Company's only resettlement housing project was launched in 2012 under BT model and was completed in 2015.

In recent years, the Company is mainly engaged in developing residential properties and urban complex projects. Given its role in city construction, the Company possessed sufficient land bank of decent quality. As at end-2017, the Company owned 72 land parcels and the area amounted to 8.9 million sqm, most of which located in Decheng District and the Economic and Technological Development Zone. About 93.5% of its land plots are of "granted" land use right, which could be transferred to third parties for residential, commercial or industrial uses, while lands plots of "allocated" land use right could only be used for public purpose and land transfer is strictly regulated.

Meanwhile, the Company is able to leverage its important position in Dezhou City and acquire land plot at low prices. In October 2017, the Company acquired a land plot at a price of approximately RMB 3,330.0 per sqm, which was about 40% lower than the auction price of comparable land plots. DDCCIO has an edge over other developers in the city given large land bank in Dezhou City and the Company's access to low-cost land.

**Exhibit 7: Summary of land plots by different land use right as of 31 December 2017**




Source: Company data, CCXAP research

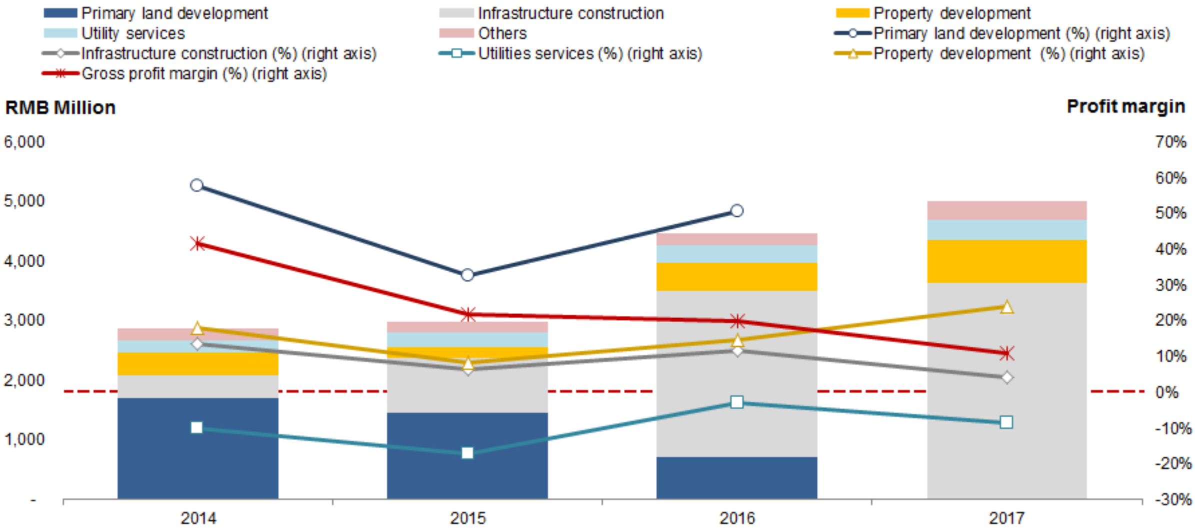
DDCCIO also cooperated with Greentown China, a major homebuilder, in residential projects. It is believed that cooperation with Greentown China would help improve the Company's operational efficiency, project management and in turn accelerate sales turnover.

As at end-2017, the Company had 3 property development projects under construction with gross investment of RMB 1,810.3 million, of which RMB 476.3 million to be invested. CCXAP expects that the Company's current capital expenditure plan would have modest pressure on its leverage. However, in the meanwhile, the cyclicity nature of real estate market would expose the Company to business operational risk.

## 5. Increasing operating revenue and narrowing profit margin

As an important infrastructure construction entity in Dezhou City, DDCCIO demonstrated a steady revenue growth along with the rapid development of Dezhou City. In 2017, DDCCIO generated total revenue of RMB 5,000.2 million, 12.2% up from 2016.

**Exhibit 8: Revenue and profit margin by business segment in 2014-2017**




Source: Company data, CCXAP research

The Company's gross margin has been on the decline from 41.6% in 2014 to 10.8% in 2017 as a result of the shift in revenue composition from primary land development to infrastructure construction. The primary land development business provided gross profit margin at around 30-50% in prior years, given the previous operational arrangement under which the Company could receive all the land sales proceeds net of taxes. The Company did not recognize any revenue from primary land development in 2017 due to uncertainties in land listing and auction. Looking forward, as the Company started to apply the new procurement model, we expect subsequent drop in gross profit margin of primary land development to around 10%-15%.

The Company's infrastructure construction segment generated gross profit margin of 3.9% in 2017, representing a noticeable drop from 11.7% in 2016. The drop was due to the change in accounting practices regarding recognition of government subsidiaries from operating revenue to non-operating income. Should previous practices were applied, the segment would produce gross profit margin of around 12.8% in 2017, representing a mild increase from prior years.

The Company's property development reported gross profit margin of 23.8% in 2017, up from prior years as a result of the expansion of residential housing market in Dezhou City.

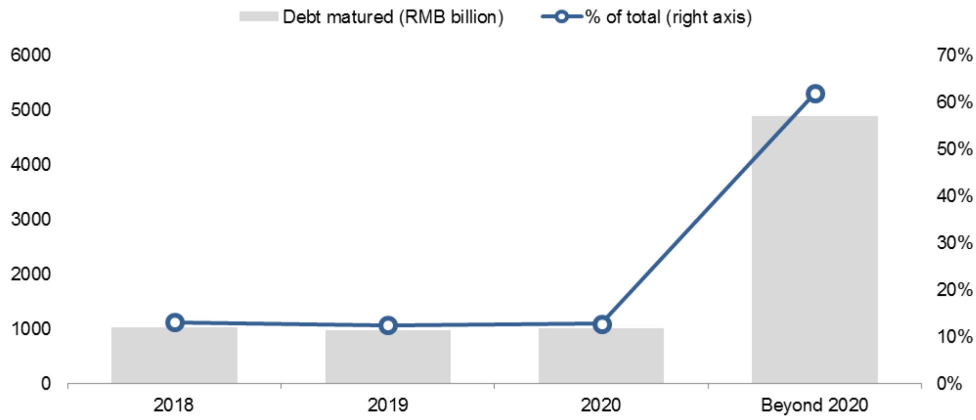
DDCCIO generated stable recurring income from its utility services segment and property investment & management business, which in aggregate accounted for 9.4% of total revenue in 2017. The utility service segment recorded sustained operating losses over the years especially in heating service. With new residential housing supplies in Dezhou City, we expect a narrowing of loss margin due to larger government subsidies, but the loss position was unlikely to change in the years to come.

Like most LGFVs, CCXAP expects the Company will continue to record highly volatile revenue and relatively low profitability due to uncertainties in land and housing markets, which could be partially mitigated by the recurring income from utility services segment and property investment & management business.

## 6. Moderate debt leverage and credit metrics

DDCCIO demonstrated moderate debt leverage and credit metrics. As at end-2017, the Company reported interest-bearing debt of RMB 7.9 billion, 34.5% lower than that of 2016. The Company recorded moderate credit metrics as reflected by total debt to EBITDA ratio of 8.2x in 2017 as compared to 19.0x in 2016 and total capitalization ratio of 28.9% at end-2017 as compared to 35.3% at end-2016. The Company's reduced leverage also helped decrease its interest expenses, and therefore EBITDA interest coverage improved to 2.3x in 2017 compared with 1.3x in 2016.

**Exhibit 9: Debt maturity profile as of 31 December 2017**




Source: Company data, CCXAP research

The Company had dispersed debt maturity profile with short-term debt to total debt ratio of 10.4%. About 61.9% of total debt will be due after year 2020.

DDCCIO's restricted assets represented a relatively low proportion and the risk of contingent liabilities was manageable. As at end-2017, the Company reported restricted assets of RMB 472.4 million, representing 1.1 % of the total assets. As at end-2017, the Company provided external guarantees to third parties of RMB 761.6 million, representing 3.9% of net assets.

## 7. Solid liquidity position

The Company has a solid liquidity position. As at end-2017, the cash to short-term debt ratio recorded 2.4x while it was 2.2x at end-2016. The Company displayed a track record of keeping the ratio above 2.0x since 2015, putting it at an advanced position among LGFVs.

As of 31 December 2017, amount of the Company's total credit facilities equaled RMB 6.4 billion, of which unutilized portion amounted to RMB 3.3 billion, indicating enough liquidity buffers in times of stress cases.

## Appendix. CCXAP's Credit Rating Symbols and their Meaning

China Chengxin (Asia Pacific) Credit Ratings Company Limited uses simple, consistent, and comparable rating symbols expressed in letters to represent the credit worthiness of rated entities and rated debt issues.

**A. Long-Term Credit Ratings**

A long-term credit rating refers to a rating for a period of more than 12 months.

| Rating Symbol | Definition |
|---|---|
| **AAAg** | Capacity to meet commitments on short-term and long-term debts is extremely strong. Business is operated in a virtuous circle. The foreseeable uncertainty on business operations is minimal. |
| **AAg+**<br>**AAg**<br>**AAg-** | Capacity to meet short-term and long-term financial commitments is very strong. Business is operated in a virtuous circle. Foreseeable uncertainty in business operations is relatively low. |
| **Ag+**<br>**Ag**<br>**Ag-** | Capacity to meet short-term and long-term commitments is strong. Business is operated in a virtuous circle. Business operation and development may be affected by internal uncertain factors, which may create fluctuations in profitability and solvency of the issuer. |
| **BBBg+**<br>**BBBg**<br>**BBBg-** | Capacity to meet financial commitment is considered adequate and capacity to meet short-term and long-term commitments is satisfactory. Business is operated in a virtuous circle. Business is affected by internal and external uncertainties. Profitability and solvency may experience significant fluctuation. Principal and interest may not be sufficiently protected by the terms of agreement. |
| **BBg+**<br>**BBg**<br>**BBg-** | Capacity to meet short-term and long-term financial commitment is relatively weak. Financial commitment towards short-term and long-term debts is below average. Status of business operations and development is not good. Solvency is unstable and subject to sustainable risk. |
| **Bg+**<br>**Bg**<br>**Bg-** | Financial commitment towards short-term and long-term debts is bad. Business is affected by internal and external uncertain factors. There are difficulties in business operations. Solvency is uncertain and subject to high credit risk. |
| **CCCg** | Financial commitment towards short-term and long-term debts is very bad. Business is affected by internal and external uncertain factors. There are difficulties in business operations. Poor solvency with very high credit risk. |
| **CCg** | Financial commitment towards short-term and long-term debts is extremely bad. Business operations are poor. There are very limited positive internal and external factors to support business operation and development. Extremely high credit risk is found. |
| **Cg** | Financial commitment towards short-term and long-term debts is insolvent. Business falls into a vicious circle. Very limited positive internal and external factors are found to support business operations and development in positive cycle. Extremely high credit risk is seen and is near default. |
| **Dg** | Unable to meet financial commitments. Default is confirmed. |

**B. Long-term Credit Rating Outlook**

A rating outlook is the medium- and long-term trend of the credit rating of a rated entity. In formulating a rating outlook, CCXAP considers the potential change in economic and commercial factors from a medium- and long-term perspective for a period of 12 to 18 months.

| | |
|---|---|
| **Positive** | Indicates a rating with an ascending trend |
| **Negative** | Indicates a rating with a descending trend |
| **Stable** | Indicates the rating is likely to be stable |

**C. Short-term Credit Ratings**

A short-term credit rating refers to a rating for a period of less than 12 months.

| Rating Symbol | Definition |
|---|---|
| **Ag-1** | Capacity to meet short-term financial commitments is extremely strong with a high level of safety. |
| **Ag-2** | Capacity to meet short-term financial commitments is strong with a high level of safety. |
| **Ag-3** | Capacity to meet short-term financial commitments is average but the safety may be easily affected by adverse business, financial, or economic conditions. |
| **Bg** | Capacity to meet short-term financial commitments is weak with a high probability of default. |
| **Cg** | Capacity to meet short-term financial commitments is very weak and the probability of default is very high. |
| **Dg** | Unable to meet financial commitments. Default is confirmed. |

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**China Chengxin (Asia Pacific) Credit Ratings Company Limited**

| | |
|---|---|
| Address: | Suites 805-808, Jardine House, 1 Connaught Place, Hong Kong |
| Website: | www.ccxap.com |
| Email: | info@ccxap.com |
| Tel: | +852-2860 7111 |
| Fax: | +852-2868 0656 |