

CCXI & CCXAP – Research & Commentary

2020H1 China's LGFV Bond Market Review and Outlook: As Financing Regulation Loosens and Market Recovers, Faith in LGFV May Further Diverge

Hong Kong, 29 July 2020 -- China Chengxin International Credit Rating Co., Ltd. ("CCXI") released an interim report entitled *"As Financing Regulation Loosens and Market Recovers, Faith in LGFV May Further Diverge"*, which contains systematic analysis on the performance of primary and secondary markets of local government financing vehicle (LGFV) bonds during the first half of 2020, credit standing of LGFV enterprises, and its outlook in the future.

CCXI stated that financing policy loosened and local government financing and trading in LGFV bonds substantially recovered during the first half year; however, under the influence of the COVID-19 pandemic, LGFV enterprises witnessed falling profitability and solvency. What makes it worse is that the amount of LGFV bonds falling due within the year will increase by 30% on a year-on-year basis. Thus, LGFV enterprises will still undergo pressure of debt repayment, and there is a probability of delayed outbreak of credit risk. Moreover, inter-region divergence as a result of the pandemic and floods, preferential policy for new infrastructure and new urbanization initiatives and major projects will aggravate the divergence of faith in LGFV of different regions and areas. It is imperative to pay attention to risk evolution.

China's LGFV Bond Market Review in 2020H1

As financing policy loosened, issuance of LGFV bonds set a historic new high, bond trading recovered, issuing cost and the yield to maturity (YTM) went down and then rose, with key rates moving downward, and credit spreads fluctuated in a broader range during the first half year. With loose financing regulation, LGFV bonds substantially expanded: total issued amount exceeded RMB2.30 trillion, representing a year-on-year growth of around 53%; total net financing amount reached RMB1.23 trillion, up over 100% year on year. Specifically, corporate bonds accounted for close to 30% of the LGFV bonds issued; the proportion of re-financing rose by 7 percentage points to 75% year on year; interest rate of LGFV bonds hit a historical low over a period of time in April before fluctuating upwards in May and June, and the key rates declined by 100BPs. Spot trading in LGFV bonds went up 16% year on year to reach RMB4,676.5 billion; YTM bottomed out at the end of April and then started to rise, with key rates moving downward. At the same time, credit spreads of LGFV bonds fluctuated in a wider range with aggravated structured divergence. Credit spreads in Qinghai and Inner Mongolia were bigger. Moreover, trading prices of LGFV bonds of poorer quality issued by local governments with poor fiscal strength or at a lower administrative level fluctuated abnormally.

In terms of credit standing, credit ratings of most LGFV enterprises were upgraded, with fewer credit events during the first half year, but their profitability and solvency apparently slipped under impacts of the pandemic. During the first half year, 84 LGFV enterprises saw their credit rating be raised, most of them from AA to AA+, the majority from

fiscally strong municipalities. The main reasons include: economy and industries of the regions developed in 2019; LGFVs played a big role in the region; local governments increased supports for them. However, the rating of Jilin Communication Investment Group was lowered from AA to AA- due to falling profitability of its main operations; Sichuan JincaiJinxin Investment Co., Ltd. was downgraded from AA- to A+ because of increased overdue loans, weak liquidity of assets and high repayment pressure. The report points out credit events of non-standard local government financing went down by 47% year on year during the first half year, mainly because the loose financing policy in response to impacts of the pandemic, debt repayment advanced by local governments and diversified channels of debt solving for LGFVs helped mitigate credit risk in a short-term. In the meantime, Guizhou Province was still a place where most defaults of non-standard financing took place, and most of them in Zunyi. It is worth noting that under lasting negative influence of the pandemic, financial condition of LGFV enterprises has deteriorated as compared to that at the end of last year. Debt burden has increased and profitability has been notably undermined. Over half of LGFV enterprises do not have enough working capital to cover interest-bearing debts.

China's LGFV Bond Market Outlook in 2020H2

Looking into the future, in spite of bettering local government financing, investors still need to stay vigilant towards risks buried under the widening structured divergence of faith in LGFV. We may pay particular attention to the following four aspects. First, we should pay heed to influence on LGFV enterprises, of inter-region divergence of credit strength under impacts of the pandemic and floods. Local government financing is dependent on supports from local governments, and part of the income comes from repayments made by local governments. The COVID-19 pandemic and floods have broadened the gap of fiscal strength between the central and southwest regions and others. This may lead to further divergence of overall strength of LGFVs. Investors should watch out for mounting credit risk of about 100 less competitive LGFV enterprises from the central and southwest regions of China that have been hard stricken by the disasters. **Second, attention should be paid to divergence of LGFVs in the process of pushing forward new infrastructure and new urbanization initiatives and major projects.** After the central government explicitly required that prioritized supports should be granted to new infrastructure and new urbanization initiatives and major projects, about 1,100 LGFV enterprises engaged in urban infrastructure construction and close to 100 undertaking new infrastructure projects will have a bettering financing environment due to more policy supports to help them transform and upgrade. Thus, the gap of credit strength between them and others will grow wider. **Third, we should pay attention to divergence of credit risk among LGFVs of middle or low administrative levels in the new urbanization initiatives.** The *Report on the Work of the Government* requires new urbanization development be prioritized to receive support. LGFVs of districts and counties that are able to undertake special T-bonds and issue special corporate bonds to support such projects will have their credit strength greatly enhanced, thus widening the gap with their counterparts. In the future, around 600 LGFVs may issue special corporate bonds that do not require additional guarantee. Investors may pay heed to such LGFV enterprises for investment opportunities. **In addition, the report also reminds investors of paying attention to repayment pressure of LGFV enterprises brought by higher economic downward pressure.** Bonds falling due and debts under resale agreement on a monthly average basis will both exceed RMB200 billion during the year. Besides, affected by the pandemic, actual

solvency of LGFV enterprises will be greatly challenged. Investors are advised to watch out for actual solvency of the six LGFV enterprises in Yunnan Province after debt swap to guard against delayed outbreak of credit risk.

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

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