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CMBI Credit Commentary

Takeaways of CMBI's LGFVs Online Forum on 4 Aug'22

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Yesterday, CMBI, Moody's and China Chengxin International Credit Rating Company Limited ("CCXI") hosted an online forum on local government financing vehicle ("LGFV"). With over 340 attendants and an over-run of 30 mins, we had some insightful discussions and exchanges on different topics such as market and credit outlook of the LGFVs in 2H22, the changing business model of LGFVs, the relationship between local governments and the credit outlook of LGFVs under the current macro environment. We summarized the key takeaways below.

CMBI: Review and Outlook of LGFV USD Bond Market in 1H22

Observations/Expectation of Offshore USD bond Market: 1) Similar to the last USD rate hike in 2017/18, the overseas financing costs have increased sharply while domestic financing has so far been relatively stable; 2) Pace of rate hikes will likely slowdown in 2H22; 3) Year to date, new issuance was dominated by short to medium USD bonds: tenor of ≤3 years and 4-5 years account for 43% and 29% of the total issuance, respectively. Besides, IG accounted for 75%, HY accounted for 15%, and non-rated (NR) accounted for 10% of total issuance in 2022.

Recap of LGFV: 1) 2022YTD, the total issuance of Chinese offshore USD bonds (including non-LGFV) fell to USD64bn, decline 37% yoy on the back of weak market sentiment and rate hikes. Trading liquidity has weakened considerably; 2) LGFV issuance increased significantly in 1H22. As of Jul'22, the number of issuance exceeded that of last year by 55 with more smaller size deals (<RMB100mn); 3) more issuance from LGFVs of district- and county-levels with lower credit ratings/credit quality and; 4) More SBLC issuance in 20/21/22 as financial profile of issuers deteriorating and market sentiment is weak.

CMBI's 2H22 outlook: 1) Large refinancing requirements resulting from scheduled maturity in 2H22; 2) SBLC will continue to be a major structure for lower-rated/credit quality LGFVs; 3) Increasing investor interests in ESG and; 4) More issuance of USD bonds or offshore RMB bonds in the free trade zone. 5). The weighting of LGFV as a percentage of Chinese USD bonds will keep increasing.

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CCXI: The Relationship between Local Governments and LGFVs

LGFVs' core businesses are mainly government projects, and sources of cash flows are mainly government subsidies/grant. Their management and development strategies are subject to the control of their respective local governments.

There are 6 evolving trends: 1) Clearer boundary between governments and LGFVs; 2) More market-oriented business model; 3) More standardized supporting patterns from governments to LGFVs; 4) Financial and debt management for local governments is more on a consolidated basis, instead of on an individual LGFV basis, within regions; 5) Deviation amongst local governments' ability to support to continue because of the deviation in economic development; 6) Re-sharping the relationship between governments and LGFVs through transformation, integration and disposals.

Future reform: 1) Insolvent LGFVs will be gradually phased out. Local governments' willingness to support the repayment of existing debts remains strong; 2) Clearing all hidden debts with pilot programs in stronger regions. Resolving hidden debts problem does not mean to cut the tie between local governments and LGFVs; and 3) Orderly proceeding the transformation of LGFVs such as those in Guangdong and Shenzhen to more market-oriented operations. There remains the needs to retain LGFVs which offer "public services" and their close tie with local governments will remain.

In practice, key rating driver for LGFVs is the willingness of government support. However, the weakening economy will undermine the ability of government support. The support will also depend on the difficulties in bail-out, the size of the problem and whether the LGFVs are considered to be "too big to fail". Furthermore, the support will depend on whether the LGFVs are performing functions in consistent with the governments' policy objectives.

Concerns on LGFVs: 1) Sluggish macro and industry policies; 2) Governments' financing and supervision policy may marginalizes some LGFVs; 3) Radical transformation to increase business and financial risk of LGFVs.

CCXI's 2H22 concerns/outlook: 1) Elimination of hidden debts and the resulting impact to economic growth; 2) How the maturity extension and coupon cut in Guizhou will affect the debt management of other provinces/regions; 3)The financial system reform below provincial levels is conducive to ease the financial stress at the district- and county- levels; 3) Limited LGFV debt supply will continue under the strict regulatory supervision; 4) CCXI forecasts that LGFV issuance will be RMB2.7tn in 2H22.

Moody's: Chinese LGFVs: Deciphering Evolving Business Models and Government Support

Increasing Special Local Government Bonds' issuance impede LGFVs' issuance. However, the issuance of special local government bonds is subject to a stringent approval process. Bond issuance from LGFVs will remain to be an important funding channel.

The crisis in the property sector led to a significant reduction in land sales revenue. In 1H22, tax cut and rebates were over RMB1.8tn, nearly 3x of that in 1H21. Land sales revenue was only 1/3 of 1H21, led to a large fiscal deficit amounted to RMB8tn in China. The land sales revenue from Liaoning, Jilin and Yunnan decreased over 50% in 1H22 yoy. This affects many local governments' ability to provide support to LGFVs.

Land sales have been an important source of local government income. For Zhejiang, land sales contributed 52.8% of the income of Zhejiang government in 1H22 while land sales contributed over 40% of the income of provincial governments of Jiangsu and Fujian over the same period. That said, Moody's is less concerned of the relatively high reliance of land sales of more prosperous provinces as there are other pillar industries in these provinces to plug the shortfall.

The credit spread differential among the developed regions and weaker regions (Northwest and Northeast) continues to widen.

LGFV issuance will increase in Greater Bay Area as under the 14th 5-year plan, incremental infrastructure investments will amount RMB5tn over the next few years.

Q&A:

Q: Will uncompleted property projects affect LGFVs?

A: So far, LGFVs rated by Moody's do not have a large participation in uncompleted property projects and the rating agency does not expect LGFVs to have a large involvement in the bail-out. No uniform solution across China to solve the uncompleted project problem. Banks will have to take more critical roles.

Q: Will more HY LGFVs come to the market?

A: The major investors in LGFV space are banks. Whether HY LGFVs can come to the market directly without credit enhancement such as SBLC depends on whether these HY LGFVs' banking relationship and availability of loan quota, based on the LGFV's standalone credit profile. Whether these LGFV come as a HY or IG with SBLC does not represent the reception of the general market on Chinese HY.

Q: Will public utilities (such as water, gas/heat and electricity) be considered LGFVs during the rating process?

A: Depending mainly on its source of repayments. If an entity's sources of repayments or cash inflow are mainly from subsidies/grant from governments, it will be more likely to be rated as a LGFV. That said, top-down and bottom-up approach should not affect the final rating. The focus of whether the rating methodology for LFGVs is used should be on the explanation of the government linkage.

Q: What is the impact of Guizhou's resolution of hidden debts to other provinces/regions?

A: The pilot program on maturity extension and coupon cut in Zunyi, Guizhou aims at resolving the hidden debt problems. There could be a good chance that the same approach will be applied to other Guizhou platforms given their similarities. Different resolution will likely be required for platforms in other provinces/regions as they are facing very different situations.

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