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Weaker LGFVs Face Greater Pressure

LGFV Credit Outlook 2023

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Key Takeaways

- We expect further differentiation in LGFVs' credit quality in 2023, considering the financing environment, regional land markets and maturity pressure. Weaker LGFVs are set to come under particular pressure regarding repayments.
- The outlook for the financing environment in weaker regions with high debt ratios remains pessimistic. Some regions face significant fiscal pressure, impacting on government support capacity for LGFVs and potentially heightening default risk. LGFVs may see more extensions and restructuring of non-standard debts, but the likelihood of a significant bond default remains low.
- We believe LGFVs in Yunnan, Tianjin, Guizhou and Gansu face particular pressure and should be monitored closely.

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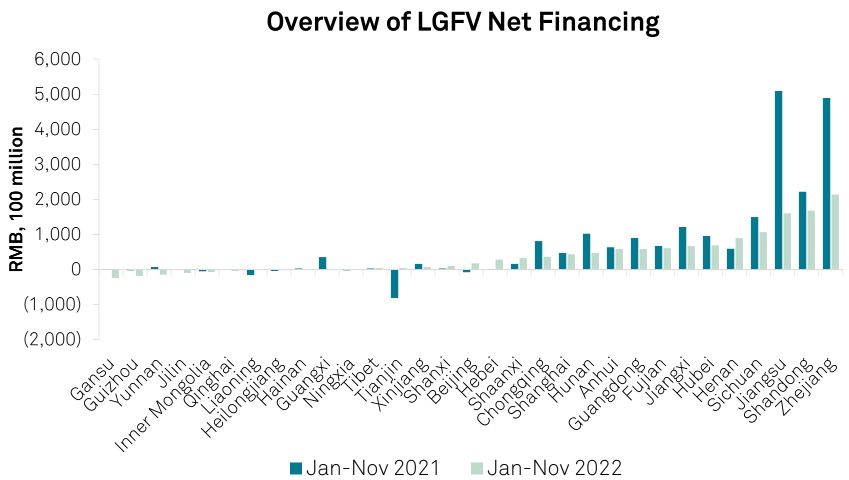
2022 Recap

2022 saw the financing environment for LGFVs tighten. Net financing of LGFV bonds was significantly lower than the previous year, with significant differentiation between regions in terms of aggregate net financing and LGFV bond spreads. In 2022, the central government maintained its strict oversight of LRG hidden debts, and the Ministry of Finance, the CBIRC and other regulatory departments issued a series of policies to mitigate LRG hidden debt risks.

This increased oversight, coupled with rising financing costs, had an impact on LGFVs' financing. From January to November 2022, LGFV bond net financing was RMB 1.21 trillion, down 41.7% YoY. There was significant differentiation between different regions. Zhejiang, Shandong, Jiangsu, Sichuan and other provinces saw significant net inflows, while Gansu, Guizhou and Yunnan saw net outflows. LGFV spreads in Gansu, Yunnan, Guizhou, Tianjin and Qinghai were significantly higher than in the eastern coastal provinces.

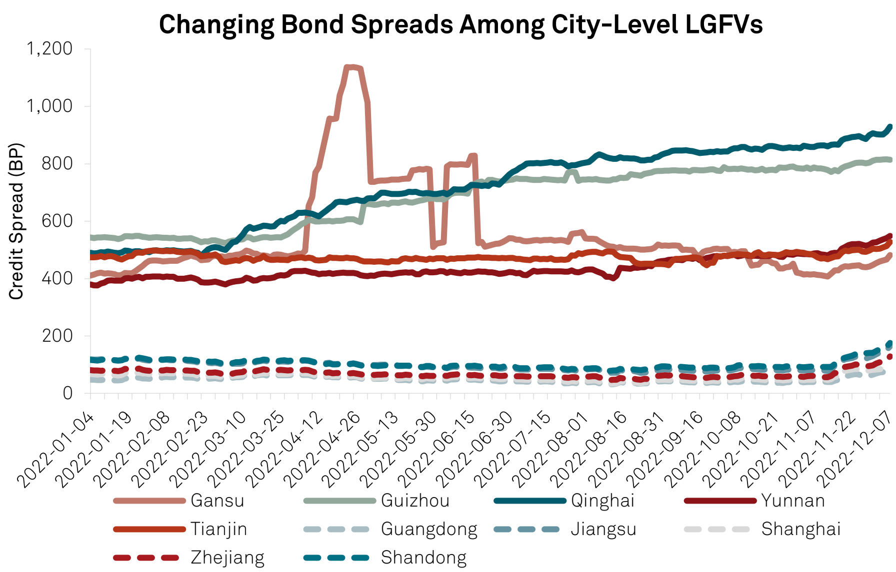
We believe these differences correlate with local fiscal and debt situations. Gansu, Yunnan and Guizhou have relatively tight fiscal positions and high debt ratios. New financing activity is restricted by certain policies. Meanwhile, investment generally flows to regions with better fiscal positions and lower debt, ultimately leading to significant regional differentiation.

Chart 1



Source: Wind, S&P Global (China) Ratings.

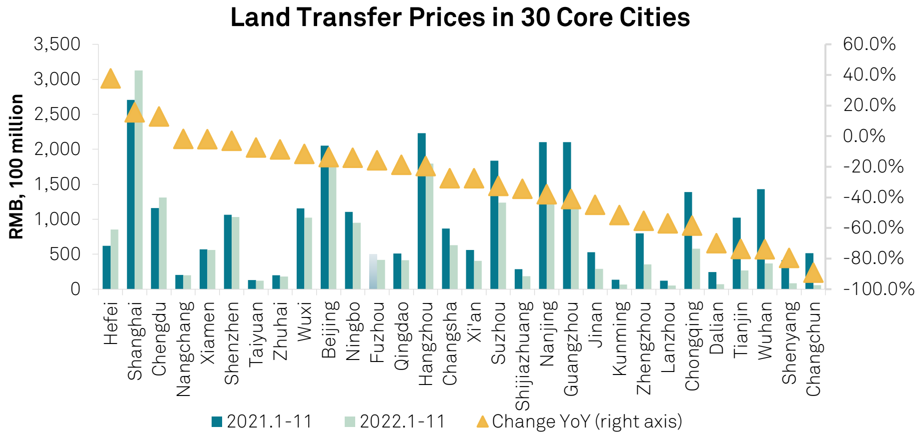
Chart 2



Note: City-level LGFVs selected with remaining maturities of 0.5-6 years in each province, spreads based on median bond spread for each province. Credit spread = bond valuation - government bond yield in the same period.
Source: DM, S&P Global (China) Ratings.

The real estate downturn in 2022 saw a significant drop in LRG land transfer revenue. Fiscal pressure in cities reliant on such revenue increased, impacting on LGFVs' cashflows and increasing their liquidity pressure.

Chart 3



Source: Wind, S&P Global (China) Ratings.

LGFV Outlook

The differentiation trend should continue over 2023, with a low number of weaker LGFVs coming under growing pressure. Risks around credit spreads or debt defaults may rise. With various adverse factors at play, growing risks among weaker LGFVs may be reflected in higher LGFV bond spreads or more defaults on non-standard liabilities, restructuring of bank debts or other credit events in certain regions.

However, considering how difficult it can be to smoothly dispose of non-standard debts and the potential implications of a credit event, governments and relevant institutions can be fairly selective in how they choose to manage potential LGFV credit risks. The likelihood of an LGFV default on a public bond remains low in the short term.

While LGFVs are set to undergo a long-term transformation in terms of the roles they play, their importance to LRGs is unlikely to change in the short term. We expect the central government to continue its strict supervision of LRGs' hidden debts in 2023, with LGFVs' financing environment set to remain tight.

In heavily indebted regions or less developed, fiscally weaker areas, the outlook for refinancing remains pessimistic. In our view, differences between LRGs in terms of economic strength, fiscal strength, debt burden and LGFV maturity pressure would continue to see differentiation in credit quality among LGFVs.

The real estate downturn and slowing land transfer activity add more pressure on LGFVs, particularly in regions that are more dependent on land transfer revenue and have higher debt ratios. Some weaker LGFVs face significant maturity pressure in 2023, and may come under some liquidity pressure. Pressure is high on LGFVs in Yunnan, Tianjin, Guizhou and Gansu, where the situation needs to be monitored closely.

Regulator to Maintain Tight Supervision

We expect financing policy to be more active in 2023, but strict oversight of LRG hidden debts will remain unchanged. Supervision of LGFV financing is set to remain tight, resulting in structural differences in terms of policy impact. Regions with better scope for borrowing may see the financing environment improve, while heavily indebted regions may see tighter supervision of LGFV financing.

At the Central Economic Work Conference in December 2022, officials said that the focus for 2023 would be adhering to the principle of stability at the same time as seeking progress, with authorities continuing to implement an active fiscal policy and prudent monetary policy.

Based on this, we expect the economy to recover to a certain extent in 2023, with consumption in particular set to improve from 2022. Real estate weakness shouldn't drag on the economy, and we expect infrastructure construction to play a smaller role in supporting growth. Fiscal policy should see more cuts to taxes and fees, amid efforts to reduce LRG debt.

The central government's strict oversight of LRG hidden debts should continue, with moderate demand for financing from LGFVs. Considering the low base in 2022, LGFV bond financing in 2023 may increase slightly YoY, but it would still be significantly lower than historical highs. In this case, regions with lower debt ratios should have more accommodative financing conditions, with a possible increase in net inflow of financing funds. Regions with high debt burdens would still struggle to access financing.

We have found that in recent years, LRGs are increasingly refinancing bonds to replace their hidden debts. This has helped to resolve debt problems around some LGFVs. However, a large number of LGFVs still need to refinance and rollover their debts, amid ongoing tight financing policy.

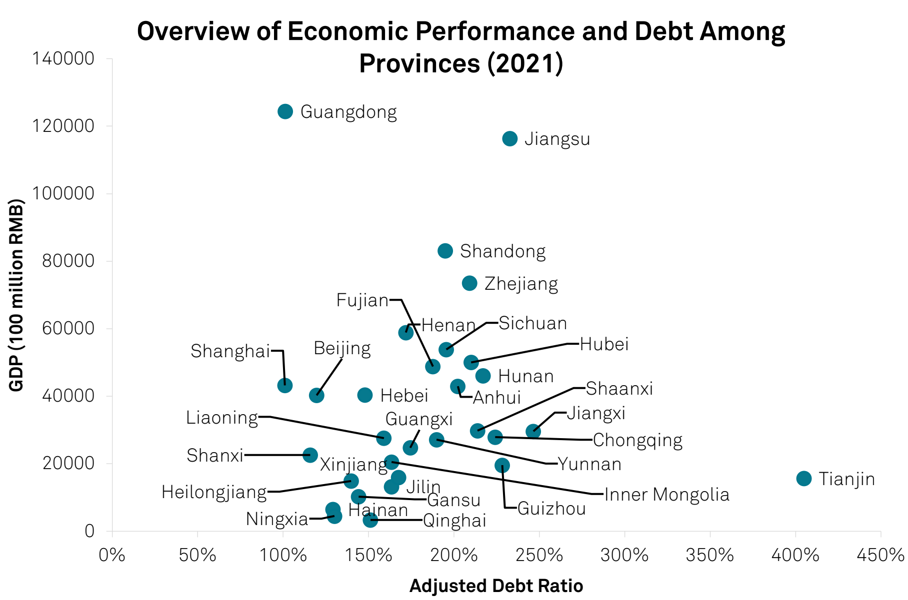
LGFV Refinancing Shows Clear Regional Differences

Differences in terms of economic position, fiscal position and debt level from region to region have, in our view, impacted on LRGs' capacity to support their LGFVs. For 2023, these regional discrepancies would also impact on LGFVs' refinancing.

In areas with stronger economic and fiscal positions and low debt risk, LGFVs have a good refinancing environment, and net financing may still be net inflow. At the other end of the scale, weaker regions with high debt burdens provide a much tighter financing environment, with high refinancing pressure.

In Tianjin, Guizhou, Jiangxi and Chongqing, regional debt burdens are inconsistent with local economic and fiscal strength. These regions have already seen some credit events involving non-standard debts. In our view, the outlook for refinancing in these regions in 2023 remains pessimistic. Financing may still be in a state of net outflow, with high liquidity pressure on LGFVs.

Chart 4



Note: Debt ratio = (LRG debt + portion of LGFV debt)/Total fiscal revenue.
Source: Government websites, S&P Global (China) Ratings.

Growing Fiscal Tightness Adds Liquidity Pressure on LGFVs

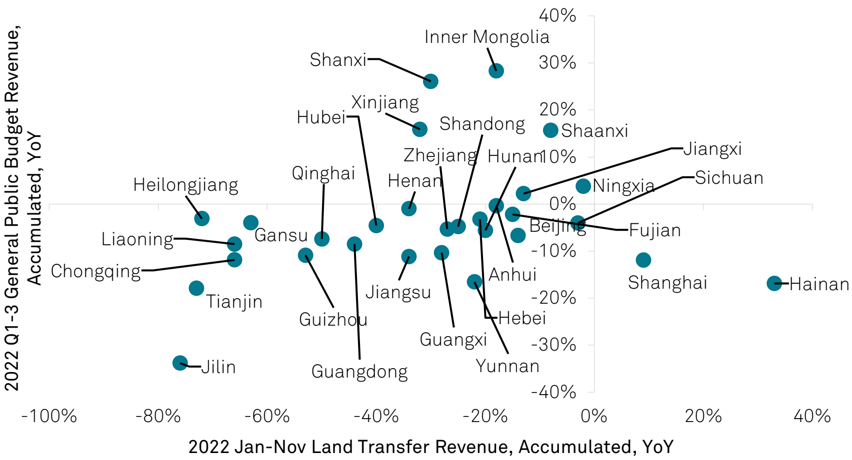
Fiscal pressure from the downturn in land transfer revenue should impact on LGFVs' liquidity. We found that land transfer revenue and general public budget revenue fell in most provinces in 2022 to varying degrees. This was especially the case in Jilin, Tianjin, Heilongjiang, Liaoning, Chongqing, Gansu and Guizhou, where fiscal pressure is growing.

In 2023, while we don't expect real estate to drag on the economy, there are few signs of significant improvement for LRGs. If provinces that have already seen significant declines in land transfer revenue continue to see weak income from land sales, fiscal pressure would gradually accumulate.

Where land transfer revenue has declined significantly, we expect greater pressure on LGFVs if local debt ratios are also high. As shown in Chart 4 and Chart 5, Guizhou, Tianjin and Chongqing are particularly exposed, and we expect their LGFVs to face greater pressure.

Chart 5

Overview of Land Transfer Revenues, Public Budget Revenues



Source: Wind, S&P Global (China) Ratings

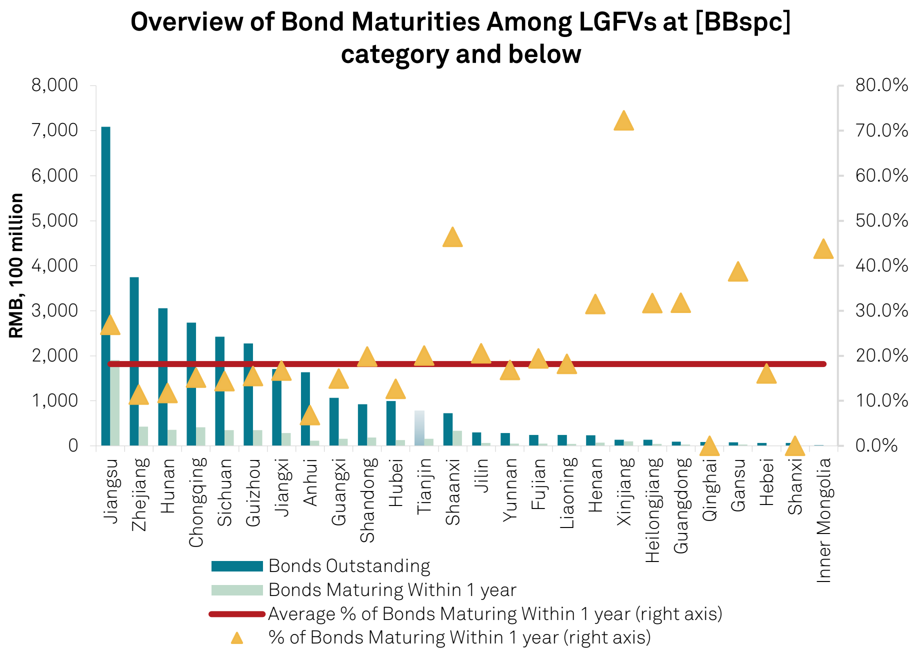
Amid Pressure on Weaker LGFVs, Debt Resolution Picture is Complex

Considering the abovementioned regional differences in financing environments and fiscal pressure, we expect 2023 to see liquidity pressure increase for low-tier LGFVs in weaker regions. Such LGFVs' credit quality may further deteriorate.

For LGFVs with weak indicative issuer credit quality (at [BB_{spc}] category or below), we analyzed their outstanding bonds and maturities within the next year. We found that LGFVs with weaker indicative issuer credit quality in Jiangsu, Zhejiang, Sichuan and Chongqing have issued a significant amount of bonds. This is due to the large number of LGFVs based in these regions, and higher local financing demand.

At the same time, LGFV issuers in Tianjin, Gansu and Hebei face significant bond maturities and exercise options in the next year. Apart from Tianjin, the absolute amount of bonds due within one year in Gansu and Hebei is not large. In addition, some weak LGFVs in Heilongjiang and Shanxi have withdrawn from capital markets and no longer conduct bond financing.

Chart 6



Note: 1. Data as of Dec. 7, 2022; 2. Data not available for Heilongjiang and Shanxi bonds maturing within 1 year.
Source: Wind, S&P Global (China) Ratings.

Amid rising liquidity pressure, 2023 may see growing credit risk exposure for weaker LGFVs. However, credit risks would largely result in defaults on non-standard liabilities or extensions of such debts, as well as bank loan extensions or restructuring. The likelihood of a default on an open-market bond remains low.

In 2022, a number of LGFVs saw non-standard debt defaults, overdue bills, bank loan restructuring and other similar credit events. These were mainly caused by high regional fiscal pressure, high LGFV debt ratios and deteriorating regional refinancing. These factors will remain in 2023, and credit events among weaker LGFVs are therefore sure to continue.

In our view, LRGs don't follow a one-size-fits-all resolution approach for such events, considering the difficulties in negotiating a debt restructure and the potential impact. LRGs have adopted multiple pathways to resolve LGFV debt problems, where the general aim is to ensure payment of public bonds while negotiating extensions or reorganizing non-standard debts and bank loans.

Restructuring a bank loan is usually relatively straightforward. Meanwhile, LRGs need to factor in the impact of credit events on the open market, maintaining the local financing environment and ensuring the refinancing of other local companies in their LGFV debt resolution strategies. The overarching goal is to uncover risks in an orderly manner, resolve regional financial risks and prevent systemic financial risks.

Close Monitoring Required

Considering LGFV financing policy and regional economic, financial, debt and land market changes, we believe that regions with low economic activity, weaker fiscal strength, high debt ratios and weaker land market activity may not provide strong support to LGFVs. In such regions, LGFVs may not receive payments in full and on time. Liquidity pressure is set to increase on weaker LGFVs in such regions. We will continue to monitor such LGFVs in regions including Yunnan, Tianjin, Guizhou and Gansu.

This report does not constitute a rating action.