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WHITEPAPER

Faith under challenge:
LGFVs’ diverging path

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Introduction

After the rapid release in 1Q 2023 of pent-up demand from 2022, the pace of recovery of China's property sector has slowed since April 2023 as growth in housing sales and land acquisitions has slackened. Along with funding pressure, construction starts and land acquisitions remain sluggish, with developers concerned about the uncertain sales recovery. Investors are increasingly sceptical about an improvement in the sector; this is pushing up property bond yields and leading to risk of delisting for a number of real estate companies.

The local-government financing vehicle (LGFV) bond market has also been in turmoil amid the unfavourable rumours flooding the market. The Guizhou provincial government's public claim about facing difficulty in deleveraging[1] and the last-minute scramble of an LGFV in Yunnan to repay debt have become hot topics[2], implying the impact of a sluggish property market on the LGFV sector and the urgent need to solve the government's "hidden debt" problem. We see the chain of risk as follows: homebuilders' funding pressure and soft contract sales – less land acquisition and a sluggish land market – less fiscal income, especially for lower-tier cities with weaker economic fundamentals – delayed and/or under-payment to LGFVs – tight cashflow at the LGFV level combined with a choking funding channel and concentrated debt maturities leading to credit events – local governments having to decide whether to bail out affiliated platforms with their limited resources.

LGFVs attempted to explore commercially viable models to support their policy function in local infrastructure development, and many of them got involved in the property market; they, thus, suffered a double blow amid the property market downturn. Although we have yet to see defaults on LGFVs' public issuance, "faith" in LGFVs, referring to investors' belief that LGFV bonds would never be defaulted on, faces a looming threat, given LGFVs' current sloughy situation and the central government's stance that it would not bail out troubled LGFVs unless it triggers a systemic crisis.

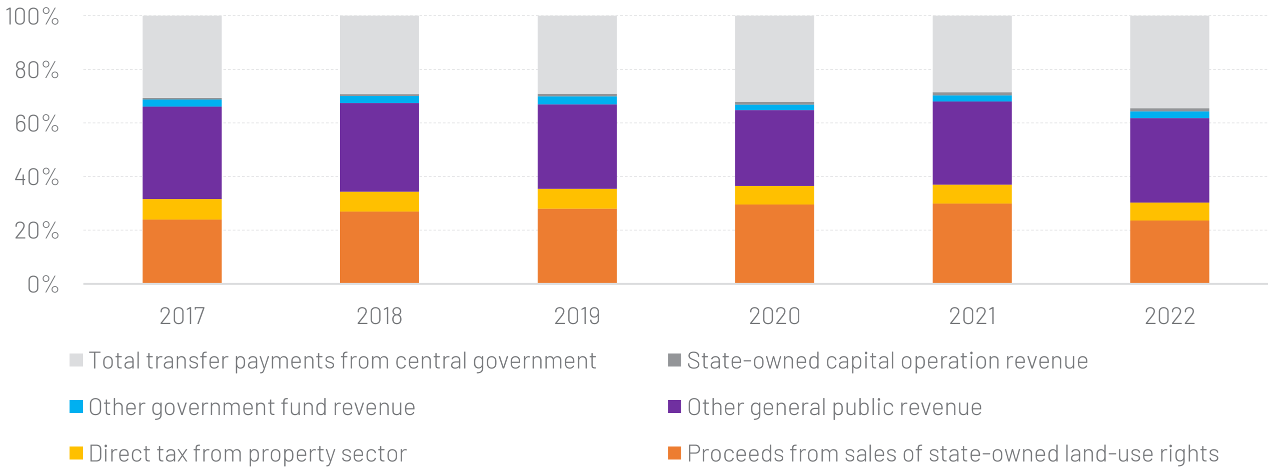
Sluggish property market and stressed fiscal revenue

China's local and regional governments' (LRGs') fiscal income is generated from four budgets: the general public budget, the government fund budget, the state-owned capital operation budget and the social insurance fund budget. Given that proceeds from the social insurance fund budget must be used for specific purposes and not at the discretion of local governments (the reason why it is not included in this paper), fiscal income from the other three budgets makes up the LRGs' fiscal strength. Revenue from the general public account and the government fund account contributes 60-70% of LRGs' annual fiscal income, forming the backbone of local governments' fiscal strength. General public budget revenue consists of taxes and a small portion of non-tax revenue; local-government fund revenue refers to funds levied from specific areas, such as sale of land-use rights and lotteries. In addition, to address the budgetary imbalance between economically developed and underdeveloped regions, the central government makes a large number of transfer payments to LRGs; these account for c.30% of LRGs' fiscal income.

With proceeds from sales of state-owned land-use rights accounting for over 90% of local-government fund revenue and direct tax income from the real estate sector accounting for c.10% of national general public revenue in past decades, the property sector directly contributed around one-third of national fiscal revenue, not including the other tax revenue from the upper and lower sections of the property value chain. "Land finance", therefore, best captures the source of revenue of China's LRGs.

1. 12 April 2023, Guantong Futures (http://m.gtfutures.com.cn/realtime/detail/933974#:)
2. 24 May 2023, Caixin (https://finance.caixin.com/m/2023-05-24/102058508.html)

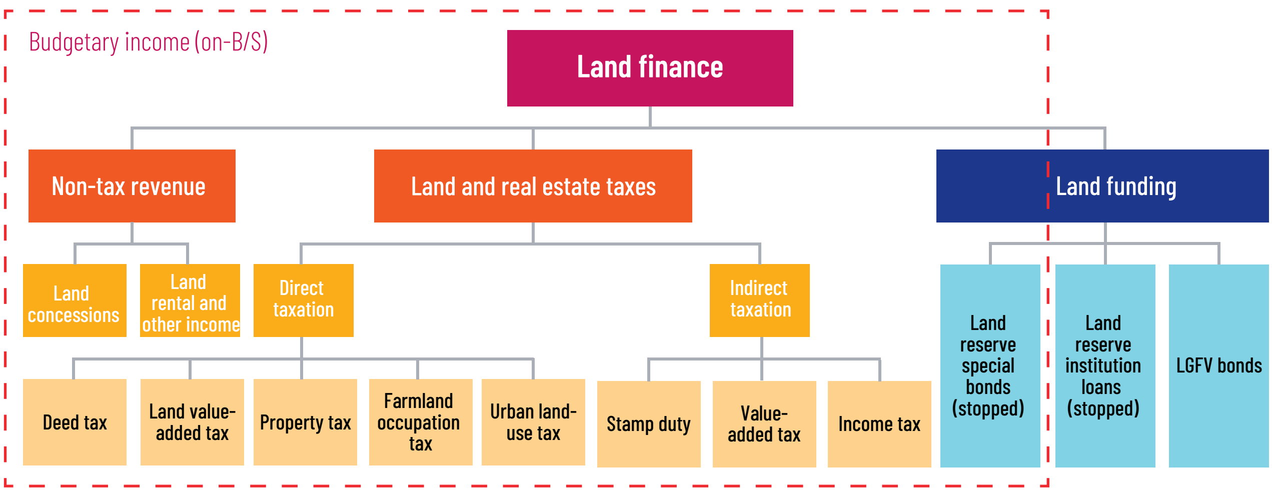
Chart 1. Breakdown of China's local-government fiscal income



Source: China's Ministry of Finance, Acuity Knowledge Partners

In China, "land finance" refers to government budgetary income generated from concessions of state-owned land-use rights and taxes related to real estate, and land-related funding[3] (see Chart 2). Under China's land reserve system, the local authorities are responsible for land pre-development (primary development) and storage, but they also monopolise the supply of primary urban land, and realise meaningful fiscal revenue through market bidding, auctions and listing of land-use rights. Homebuilders are the targeted buyers of state-owned land-use rights. They procure the land, complete the secondary development of property and sell to homebuyers – spanning the entire property value chain. Taxes are generated along the chain, which involves developers, contractors, material manufacturers and homebuyers. LRGs used to issue land reserve special bonds and use land as collateral to obtain land reserve institution loans (these activities have now been stopped). Local governments also inject land assets into subordinate LGFVs to puff up balance sheets of those platforms and facilitate their funding. The rapid development of China's property market since the early 2000s has enabled LRGs to meet their capital spending needs even in areas with weak economic fundamentals.

Chart 2. Land finance in China

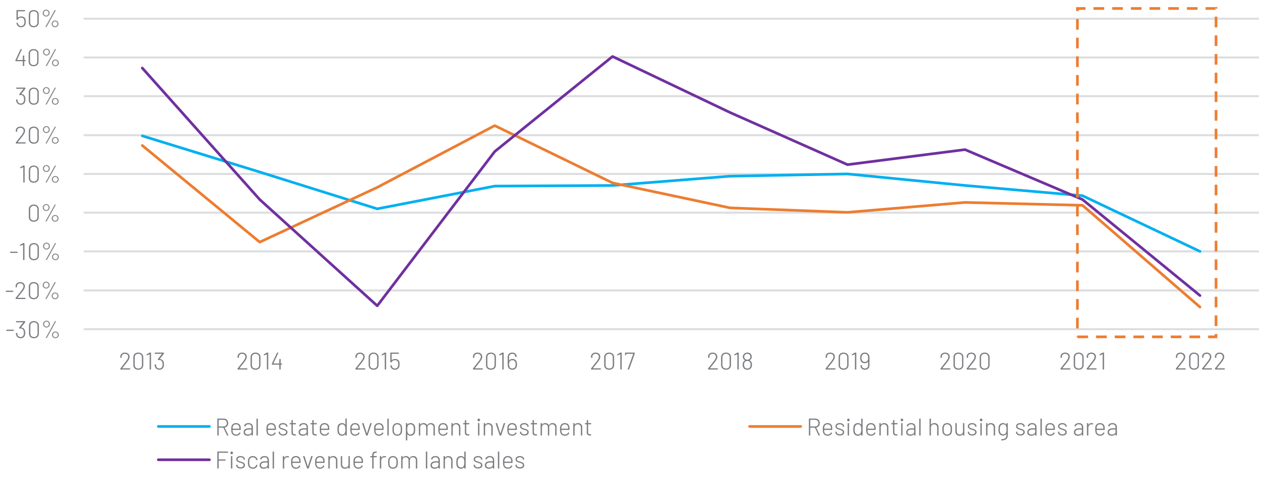


Source: Acuity Knowledge Partners

3. 24 May 2023, Caixin (https://finance.caixin.com/m/2023-05-24/102058508.html)

A booming property market is the premise of land finance, and the current setback in housing and the land market has challenged the sustainability of land finance more than ever. China's real estate development investment declined 10.0% y/y in 2022, and residential housing sales area fell 24.3% y/y, increasing housing stock by 10.5% y/y in terms of area available for sale. The slump has continued in 2023, with real estate development investment declining 7.9% y/y and residential housing sales area falling 5.3% y/y in the first half. Government fund revenue dipped for the first time in seven years in 2022, mainly due to the continued decline in land transactions as a result of less land acquisition by real estate companies. Despite a number of policies being implemented to prevent a further hard landing of the real estate market, the recovery has been more lacklustre than market expectations.

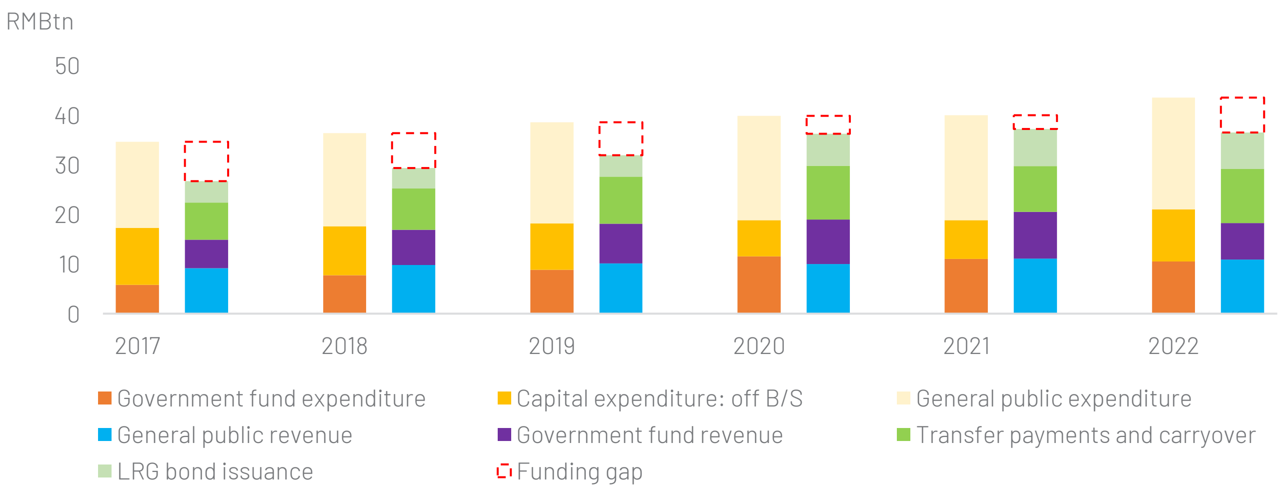
Chart 3. Growth (y/y) of property-market indicators and fiscal revenue from land sales



Source: Wind, Acuity Knowledge Partners

The National People's Congress set a strong GDP growth target of 5% for 2023 at the annual meeting in March, after the 2022 growth target was missed. Such a target, set amid domestic economic pressures and external uncertainties, leaves little room for local governments to scale back fiscal expenditure, and infrastructure investment could be used to drive economic growth. With less proceeds from land sales and more expenditure required, LRGs' fiscal deficits reached a record high of RMB11.6tn in 2022, widening the funding gap, especially for underdeveloped regions with less tax income and large exposure to land sales.

Chart 4. LRGs' fiscal deficits and the funding gap

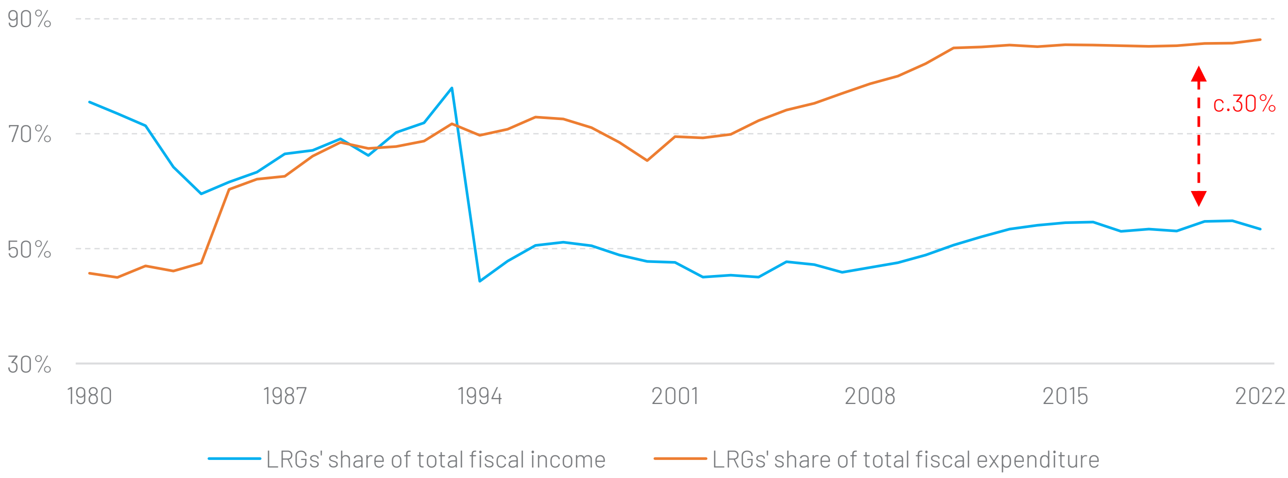


Source: China's Ministry of Finance, Wind, Acuity Knowledge Partners

LGFVs and land funding

LGFVs emerged alongside China's accelerated urbanisation as a result of the imbalanced legal relationship between central and local governments in terms of control over fiscal resources and administrative obligations in urban development and public services expenditure. This was after the reform of the tax-sharing system in 1994, when LRGs' share of tax income dropped from c.70% to below 50%, although they still bore 70% of fiscal expenditure. Meanwhile, local governments were not allowed to participate in the capital market until 2009, and lower-tier governments (municipal and county-level governments) still have no direct access to the bond capital market[4]. To meet expenditure requirements, given the shortfall in tax income and funding constraints, LRGs had recourse to land finance and began to set up local financing platforms, i.e., LGFVs, to raise funds and undertake infrastructure projects on their behalf.

Chart 5. LRGs' share of fiscal income and expenditure



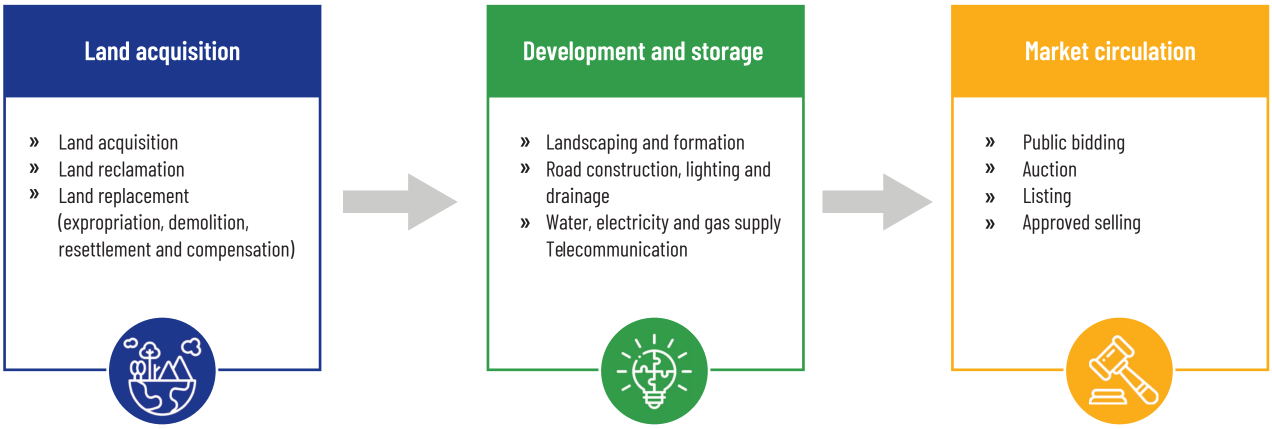
Source: Wind, Acuity Knowledge Partners

Most public infrastructure projects undertaken by LGFVs had limited financial returns or were less attractive to private-sector investors, and LRGs were actually the purchasers of these public projects. Thus, LGFVs relied on government payments, and eventually fiscal revenue, to realise project cash collection. LGFVs also had to bear a significant amount of debt, helping local governments to bridge the funding gap in urban development.

Primary land development is one of the traditional businesses of LGFVs. The general process of land reserve includes land acquisition, land storage and market circulation (see Chart 6); LGFVs mainly carry out the preliminary development and consolidation of land – the most important activities in the process[5]. At present, LGFVs engage in land development as entrusted by land reserve agencies – government agencies under LRGs. Local land reserve agencies pay the project cost plus a margin (usually very thin) to LGFVs, with land concession revenue being the source of payment. Under the entrusted approach, the LGFV compensates for demolition and resettlement during the land acquisition stage and engages in construction of urban infrastructure such as roads, water supply, electricity supply, gas supply, drainage, telecommunications, lighting, landscaping and land formation during the land development stage.

4. Only provincial governments (including autonomous regions and municipalities directly under the central government) and the five municipalities (Dalian, Qingdao, Ningbo, Xiamen and Shenzhen) with independent planning status can issue government bonds in China's domestic capital market.
5. China Bond Rating, *Series Study on LGFVs' operations: Analysis of LGFVs' Land Development Business*

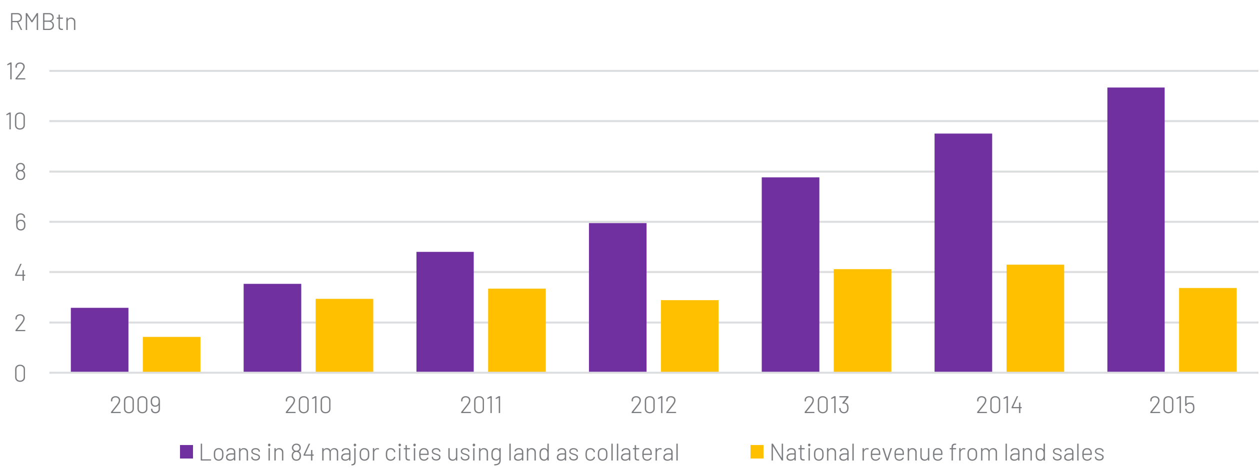
Chart 6. General process of primary land development



Source: China Bond Rating, Acuity Knowledge Partners

In such a process, LGFVs provide services to LRGs before governments can generate revenue through concessions from developed lands. Thus, there is lag in fund provision, and LGFVs accumulate large amounts of government receivables on their books. They then need to finance capital outlay during the development period, which could take years. In a lacklustre land market, such as the one China has been experiencing since 2022, LRGs' revenue from land sales shrinks, making it more unlikely that they would be able to pay LGFVs on time. For LGFVs, the thin margins and long project cash cycles of primary land development and other infrastructure projects would not help them meet the large capital requirements due to accelerated urbanisation. Loans using land as collateral were, therefore, a fast way to monetise land resources – some of the few public resources local governments could deploy at their discretion. To catch up with the rapid growth in capital demand from city development, land-collateral loans started to dominate from 2011, and land-collateral loans in 84 major cities reached 3.4x national revenue from land sales in 2015.

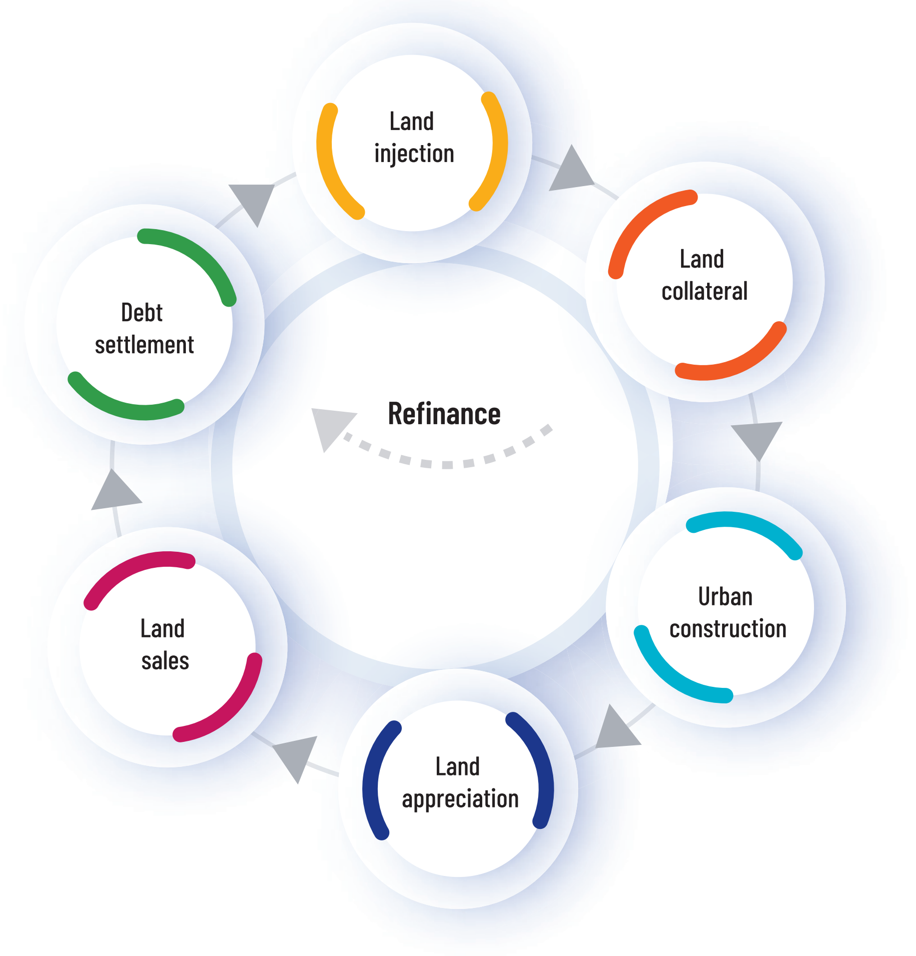
Chart 7. Comparison of loans using land as collateral and land concessions



Source: Wind, Acuity Knowledge Partners

The booming real estate sector drove the spike in land prices for over a decade, not only generating revenue for the government, but also boosting the cities' financing capacity. Many local governments injected substantial amounts of land into LGFVs to enhance the collateral available to them. With implicit credit endorsement from governments (even guarantees in the past) and land as collateral, the platform companies were favoured by financial institutions. Funding was obtained to meet capex on infrastructure, and increased urban construction raised land values. This method of land funding enabled LGFVs to accumulate and roll over debt with limited operating cash inflow.

Chart 8. Land funding through LGFVs



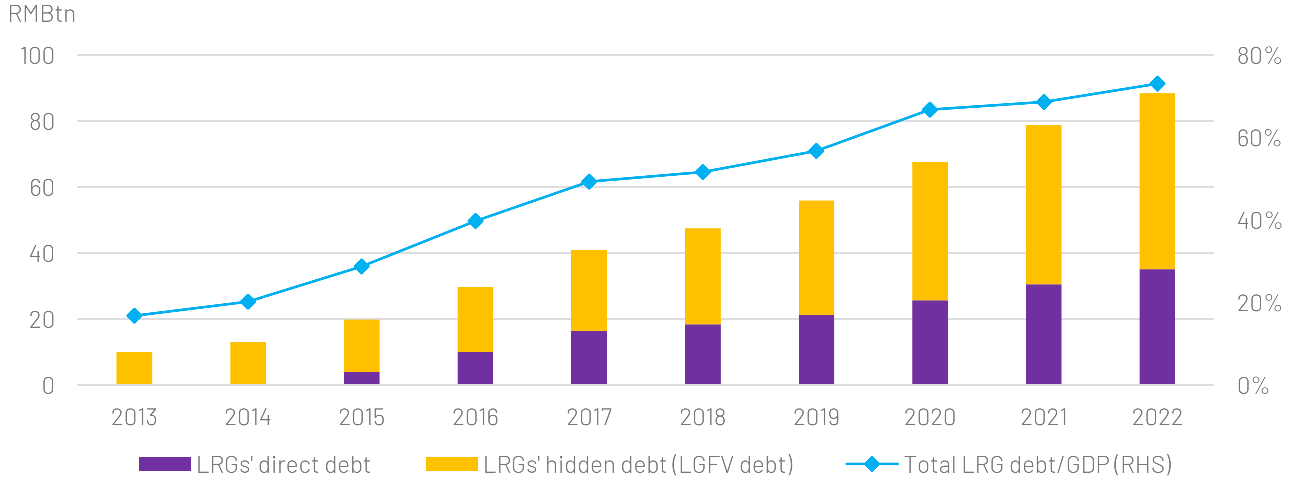
Source: Acuity Knowledge Partners

Hidden local-government debt and the rise and fall of LGFVs

The rise

Facilitated by this method of land funding and fiscal stimulation amid the financial crisis in 2008, LGFVs' debt grew exponentially, at a CAGR of 20.3% from 2013 to 2022. Given LGFVs' close ties with local governments in terms of shareholding, daily operations, revenue and reimbursements, and funding resources, LGFV debt has come to embody local-government debt, often referred to as LRGs' off-balance-sheet or hidden debt. Direct debt of China's LRGs (the sum of general and special government bonds) was RMB35.1tn as of end-2022, and the balance of LGFV debt nationwide was RMB55.4tn, far exceeding LRGs' direct debt.

Chart 9. LRGs' direct and hidden debt and leverage ratios[6]

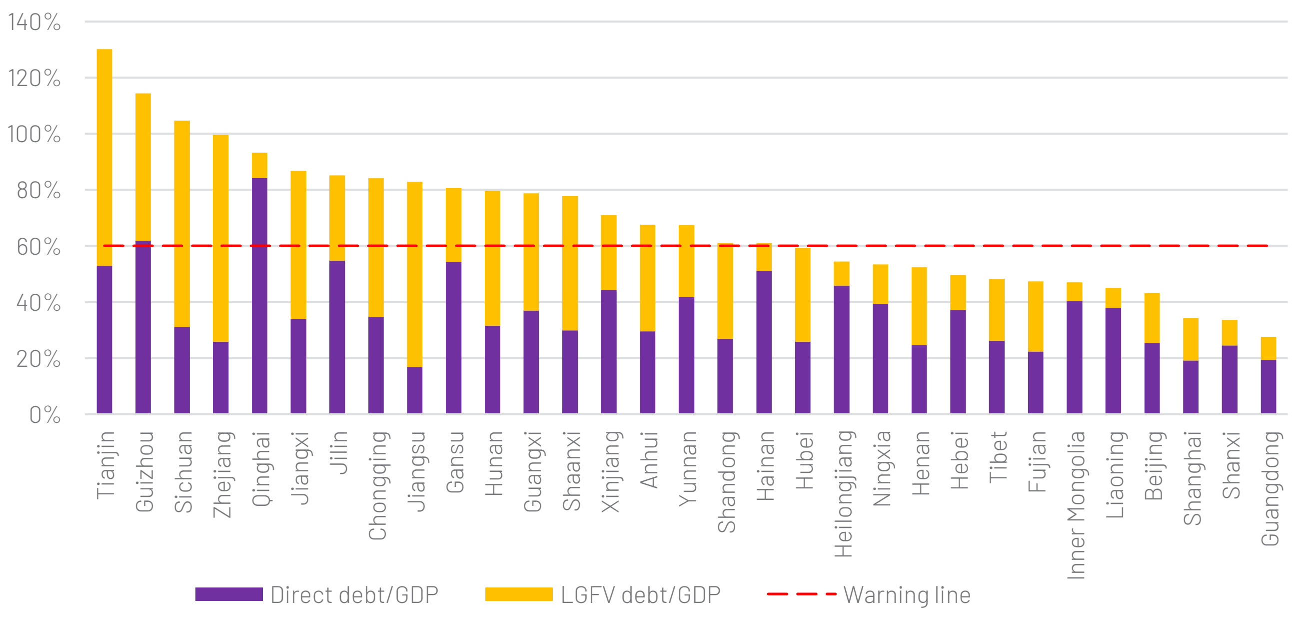


Source: Wind, Acuity Knowledge Partners

LGFVs' role in public projects and explicit or implicit government endorsement of LGFV debt have blurred the boundary between LGFV debt and local-government debt, and the market has equated LGFVs' credit with LRGs' credit. For this reason, LRGs' actual leverage was far more than the figures on their books. An excessive burden of hidden debt has exacerbated the situation of provinces with weak economies. The implicit debt ratios of Tianjin, Guizhou and Sichuan have surpassed 100% (maximum government leverage is generally set at 60%).

6. The central government issued and repaid (2009-11) or only repaid (2011-14) local-government bonds on behalf of LRGs; since 2015, all provincial governments have had the right to directly issue and repay local-government bonds in the capital market through legislation.

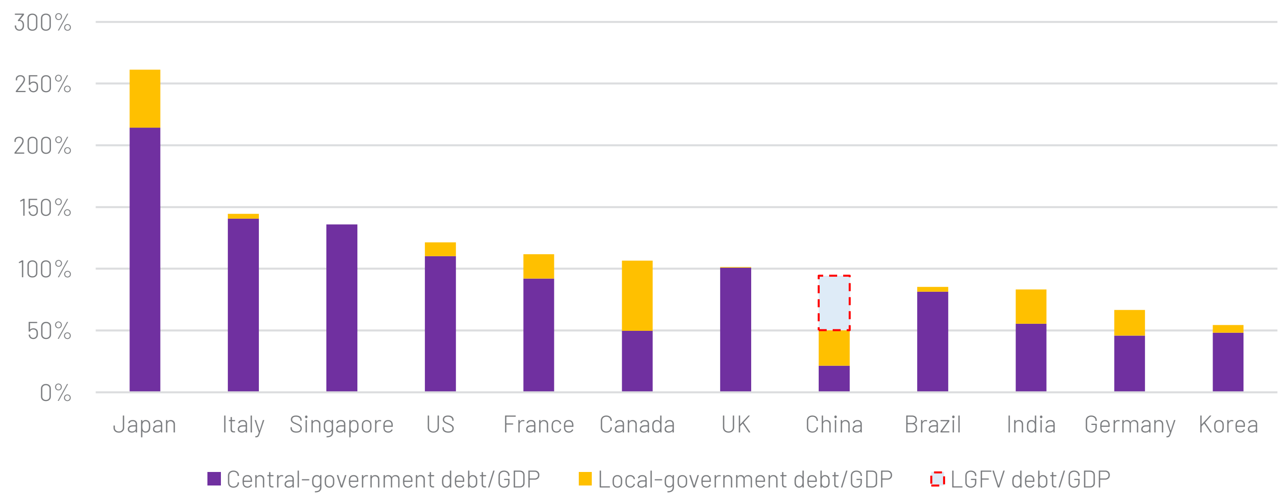
Chart 10. LRGs' debt ratios by province (as of December 2022)



Source: Wind, Acuity Knowledge Partners

Leverage of China's public sector was not surprisingly high on a global level – still lower than that of many developed markets' such as Japan, Singapore, the US and certain European countries. While the central government's debt is tightly managed, China is the only country that bears an overwhelming portion of public debt at the local-government level, with over half of local-government leverage being off-balance-sheet debt taken by LGFVs.

Chart 11. Government leverage by major economy (as of December 2022)

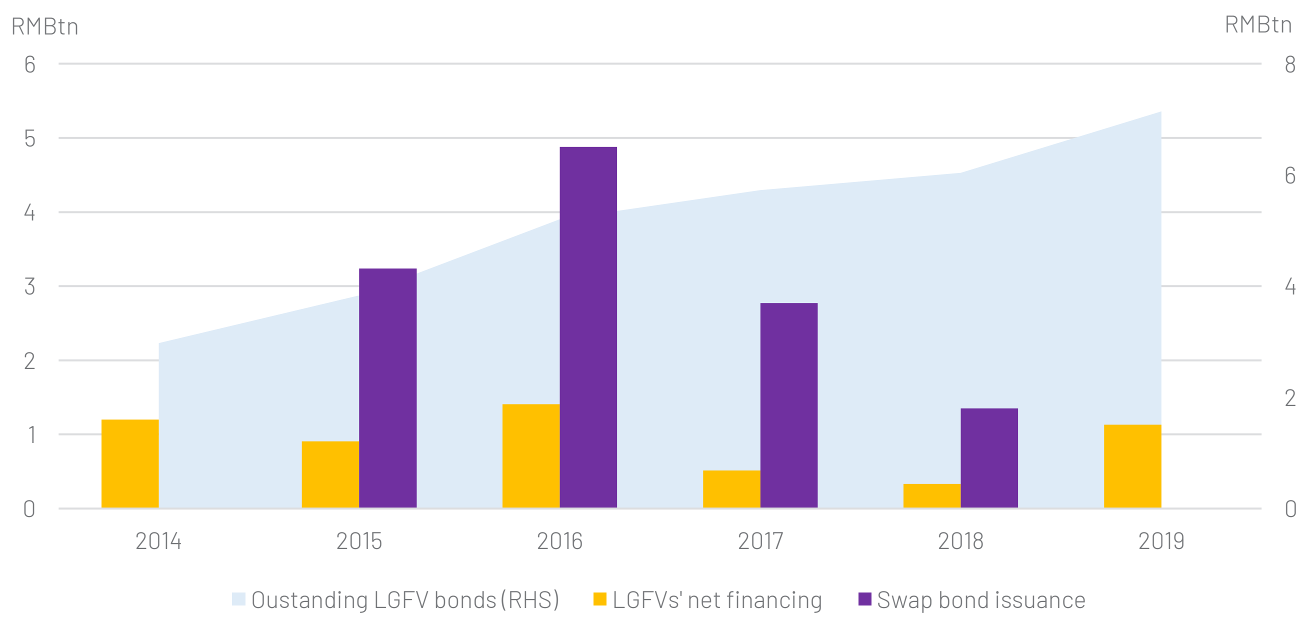


Source: Wind, Bloomberg, Acuity Knowledge Partners

The tightening

High local-government leverage alerted China's central government, and the substantial amount of "hidden debt" is the most pressing issue. The central government started to identify and separate government debt on LGFVs' books, strip LGFVs of their function as the government's financing platform and prohibit LRGs from offering guarantees or explicit credit endorsement to LGFV debt. Under the central government's instructions, LGFV debt was classified and identified as "government debt" and "contingent government debt". A debt-swap programme was launched in 2015-18, and local governments issued RMB12.2tn worth of LRG bonds and used the proceeds to swap back LGFV debt recognised as "government debt", aiming to shift off-balance-sheet debt onto their balance sheets. The remaining LGFV debt, referred to as "contingent government debt" and still substantial, is to be repaid through LGFVs' own operating cashflow. That said, local governments are responsible for the potential bailout of "contingent government debt", as stated in the central government's announcement.

Chart 12. Debt-swap programme and outstanding volumes of LGFV bonds

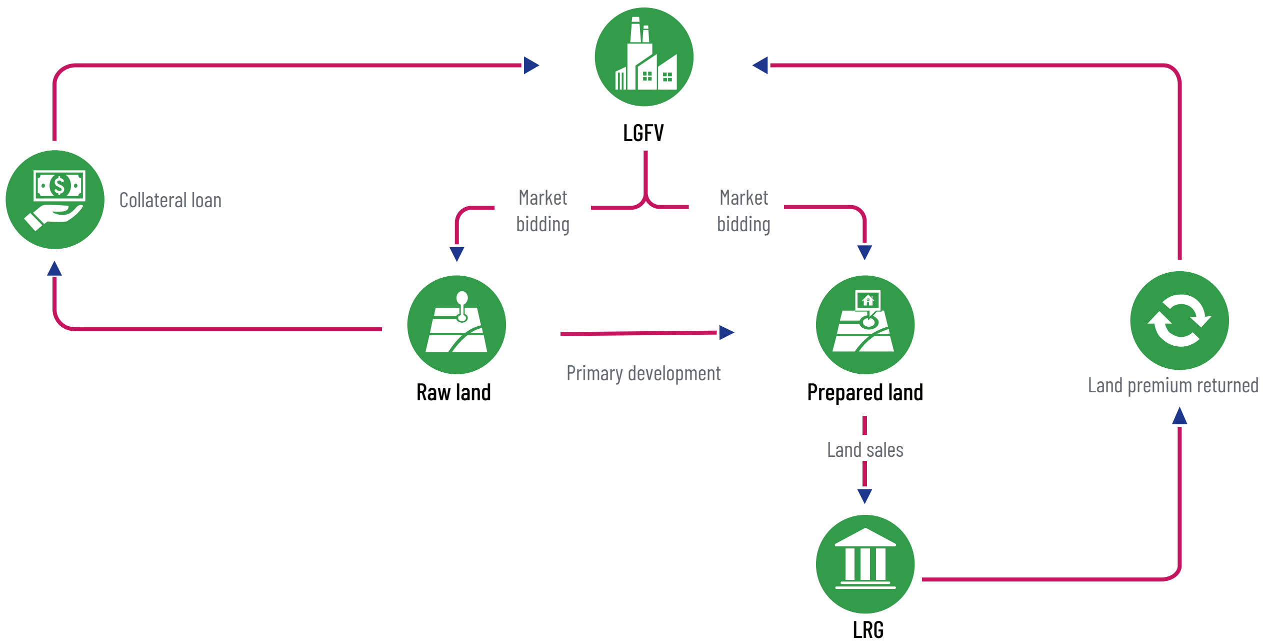


Source: Wind, Acuity Knowledge Partners

Curbing growth is key to digesting outstanding debt. Although LGFVs' financing policies have been tightened and relaxed against different macroeconomic backdrops, the core policy trend is to defuse LRG debt risk and restrain growth in hidden debt. Regulation has been limiting local governments' ability to inject land assets into LGFVs[7] since 2012, shaking the foundation of land funding, but LRGs have found a way around regulatory constrains – LGFVs purchased land in market bidding and paid the land premium, and local governments returned the land premium to LGFVs (see Chart 13). However, this process has been difficult to implement since the tax department took charge of collecting land premiums in 2021[8].

7. 31 December 2012, China government (https://www.gov.cn/gzdt/2012-12/31/content_2302905.htm)
8. 21 May 2021, China government (https://www.gov.cn/zhengce/zhengceku/2021-06/04/content_5615524.htm)

Chart 13. Returning land premiums – illustrated



Source: China Bond Rating, Acuity Knowledge Partners

LGFVs also face tight regulation and a lengthy approval process when tapping into the debt capital market. For example, LGFVs from regions where local-government leverage is high are prohibited from issuing bonds; LGFVs whose outstanding bond amounts exceed 8% of local GDP or government receivables exceed 60% of their equity are also banned from participating in the bond market. In addition to these restrictions, use of proceeds from bond issuance is clearly defined (see Appendix), creating obstacles for LGFVs issuing bonds in the capital market. Given how public markets are sensitive to confidence, tightening regulations in terms of LGFV financing, increased pressure on government payments and the central government's move to detach LGFVs from government credit were reducing investor appetite for LGFV bonds. This resulted in shortened issuance tenors and frail net financing for LGFVs, leading to liquidity and funding risk to local platforms.

Continued softness in the property sector has increased uncertainty around land assets, reducing their value as collateral; on one hand, this constrains LGFVs' ability to raise new funding, and on the other, it could trigger a debt covenant, requiring LGFVs to replenish collateral. In addition, the slowdown in land transactions has made land assets stickier and difficult to liquidate. The deterioration in both collateral value and quality has undoubtfully made things worse for LGFVs' limited funding ability.

The transformation

Amid tightened regulatory requirements aimed at containing hidden government debt, the business model for LGFVs' traditional public projects was being transformed. The old model based on build-transfer (BT) contracts, where local governments are responsible for buying back project assets and acting as the ultimate borrower of project loans, has been phased out[9]. LRGs are supporting LGFVs' public projects through equity injection, government subsidies and allocation of government special bond proceeds to avoid incremental hidden LRG debt and remain compliant with regulatory requirements. LGFVs are also exploring ways to create profits, apart from the traditional thin-margin infrastructure development projects, to manage the heavy debt burden and tightened funding conditions. Some platforms forayed into the property development and construction sectors, leveraging their expertise and resources. LRGs rich in public resources started injecting or transferring cash-generating assets (such as utilities, toll roads, office buildings and other state-owned operating assets) to subordinate LGFVs to strengthen LGFVs' earnings and cashflow performance.

During the market-oriented transformation of LGFVs to enhance profitability and debt-service ability, LGFVs took three main paths: as (1) utility operator, (2) property developer or construction company, or (3) investment holding company.

9. 31 December 2012, China government (https://www.gov.cn/gzdt/2012-12/31/content_2302905.htm)

Utility or transport operator: LGFVs are often engaged in the development phase of utility and transport infrastructure projects such as heat, water, electricity, gas and toll road projects in a particular region. Leveraging the strong franchise built on their monopoly in a region, LGFVs generate stable inflow when utility or toll road projects are in the operating phase; the better the regional economic conditions, the greater the market potential for utility business. As a quasi-public product business, utility providers can expect to receive a certain amount of government subsidies and tax incentives.

Property developer or construction company: LGFVs have accumulated expertise and resources in land development, infrastructure construction and affordable housing construction projects, and are often professionally qualified to construct housing, roads and bridges, making it easy for them to transform into construction engineering enterprises or real estate developers, leveraging their advantages in land resources and links with the government. However, amid a property-sector downturn, suppressed commercial housing sales could hardly be the crutch replacing reduced government payments for traditional projects.

Investment holding company: In more economically developed areas, where local governments hold a considerable number of state-owned entities (SOEs), these governments may transfer the equity holding in local SOEs to subordinate LGFVs, making them a holding and operating platform of state-owned assets. LGFVs may report better financial results due to commercial businesses being consolidated in their statements, but they would also be affected by the cost and funding method when acquiring such business units and the leverage of the combined business. Instead of being an operating platform, LGFVs could also evolve into an investing platform, setting up investment funds based on their original industrial foundation, taking the leading role in the development of strategic regional industries and realising investment gains.

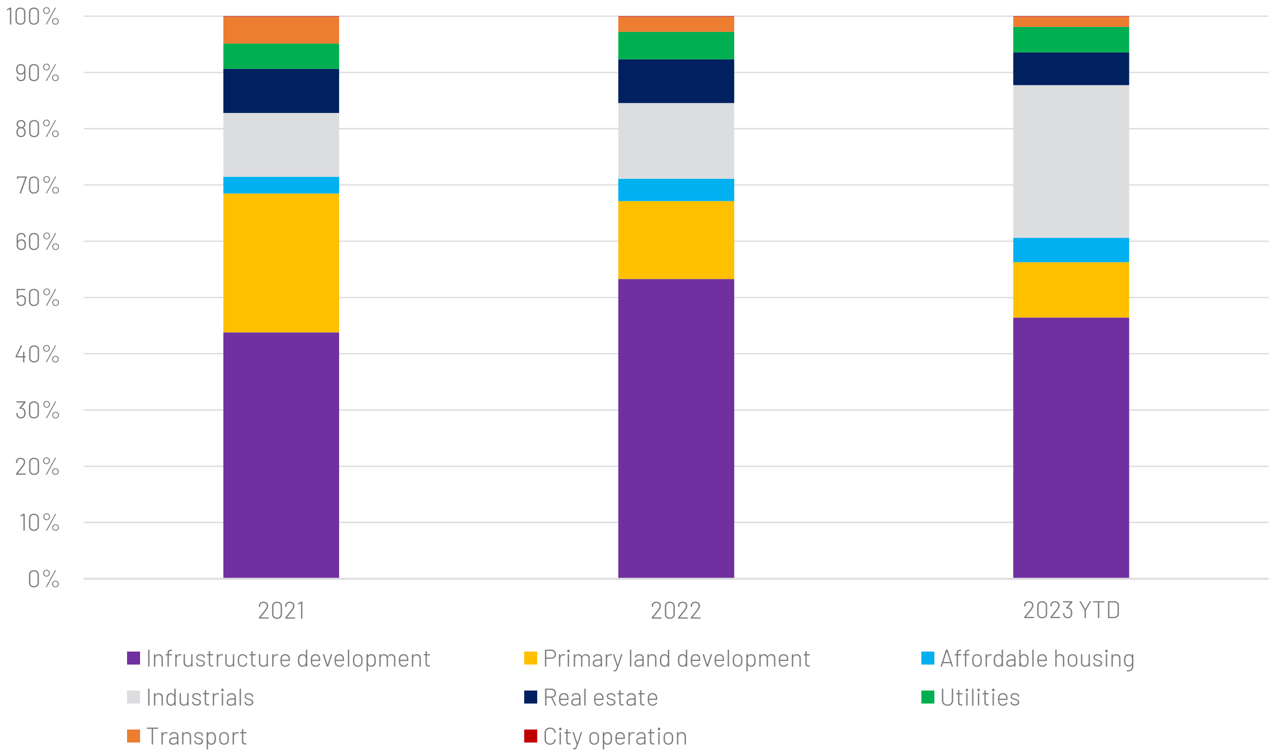
Chart 14. Main types of LGFVs' market-oriented transformation

	Utility/transport operator	Property developer/ construction company	Investment holding company
Market-oriented business	Water supply and sewage, heating, gas, city pipelines, toll road operations	Construction projects, development and lease of residential, commercial and industrial real estate	Cross-sector commercial operations, financial investments
Resource requirement	Operating-phase utility, public transport and transport infrastructure assets	Construction qualifications, land-bank resources	SOE resources held by LRGs, government capital injection
Additional source of cashflow	Operating revenue, fiscal subsidy	Construction project revenue, housing sales, rental income	Operating revenue, investment gains, fiscal subsidies
Leverage	Low (assuming development-related leverage has been paid down)	High	Mixed (depending on acquisition cost and funding method, and leverage of consolidated units)

Source: Acuity Knowledge Partners

Market-oriented transformation is one of the key ways in which to digest contingent local-government liabilities borne by LGFVs, with these local platforms likely able to better manage their debt with more operating profit and cashflow. That said, the traditional infrastructure development business is still the core mandate of LGFVs, accounting for 60% of revenue, despite the transformation trend. Market-oriented transformation is not applicable to all LGFVs; for example, platforms with weak operating fundamentals are often in less economically developed regions or owned by lower-level governments that rely more heavily on land finance and have fewer public resources to support the market-oriented transformation of local platforms.

Chart 15. Change in LGFVs' revenue composition

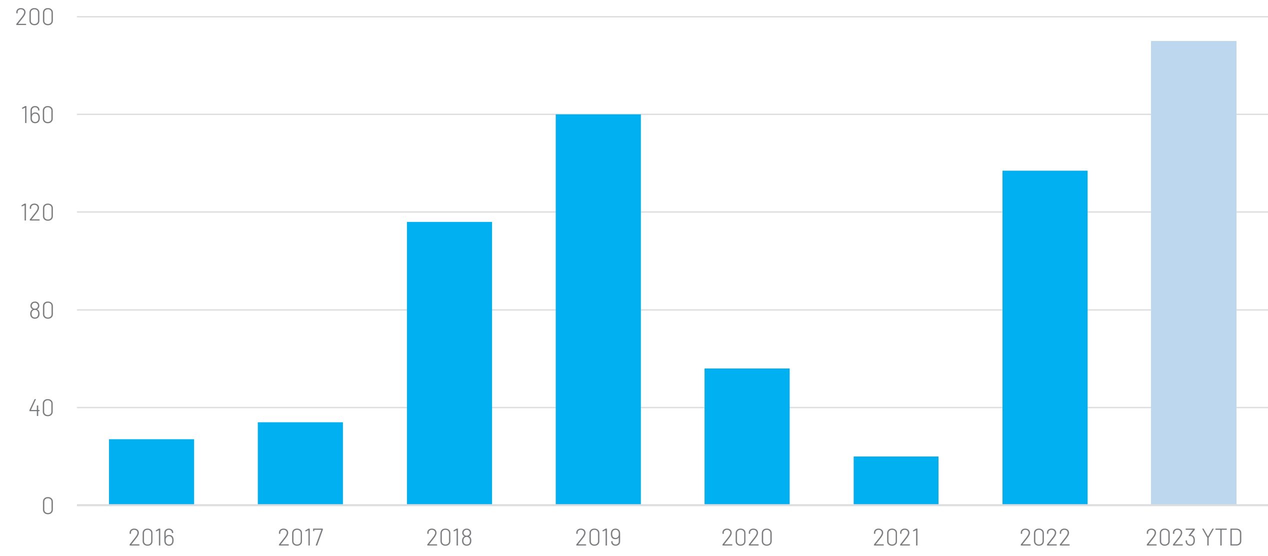


Source: Wind, CICC, Acuity Knowledge Partners

LGFVs have also been "exiting" the status of financing platform. It was reported as of September 2023 that more than 190 platforms had announced not functioning as a government financing vehicle[10], another peak of exits since 2019. However, giving up the status does not necessarily mean that the LGFV would refrain from regional infrastructure development, city operation and public asset management activities. In most cases, these are attempts to (1) comply with regulatory requirements, (2) overcome financing-related obstacles and (3) participate in public projects as a non-public-sector entity, for example, in public-private partnership (PPP) projects[11]. Exiting platform status did not change the business fundamentals of LGFVs, but only eliminated the simple "LGFV borrows-LRG pays" model and made the cashflow matching between government support and LGFVs' investment activities less direct. For this reason, market investors still treat companies that have announced forgoing platform status as "LGFVs" when conducting analysis.

10. 9 September 2022, The Economic Observer (https://m.eeo.com.cn/2023/0909/604775.shtml)
11. 28 October 2022, Funder Securities, *How to understand LGFVs' exiting of platform status*

Chart 16. Number of LGFVs announcing exit



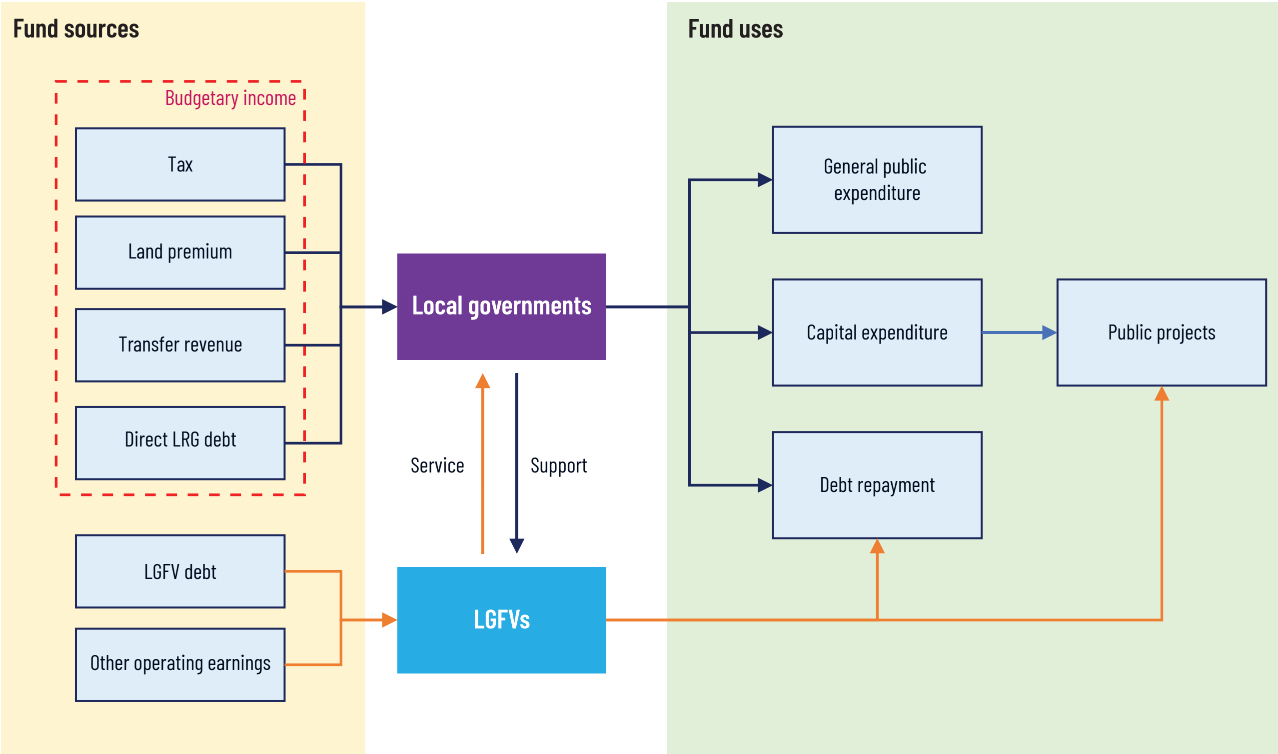
Source: Local governments, Industrial Securities

Faith in LGFVs floundering?

LGFVs will likely remain instrumental in public projects, despite the evolving LRG-LGFV relationship and LGFVs' changing business model. China's 14th Five-Year Plan includes infrastructure investment plans relating to public housing and urban upgrades, ecology-oriented development, integrated transport networks, rural revitalisation, digital infrastructure and development of city clusters, where LGFVs could play an essential role[12].

The general logic underlying the LRG-LGFV issue is clear: imbalanced fiscal power and administrative expenditure obligations, the pressing need for economic development and inadequate funding channels led to excessive LGFV debt. If LRGs cannot obtain enough funding, either from fiscal revenue or external financing, and they continue to bear the direct responsibility for public project developments, demand for alternative funding would continue. Meanwhile, as long as LGFVs maintain their role in public project investments and operating profits are not sufficient to cover the leverage taken on over the years, the need for government support would remain, in the form of government payments, cash equity injections, special bond allocations or government subsidies – key for LGFVs fulfilling their policy mandate.

Chart 17. Logical path of the LRG-LGFV relationship



Source: Acuity Knowledge Partners

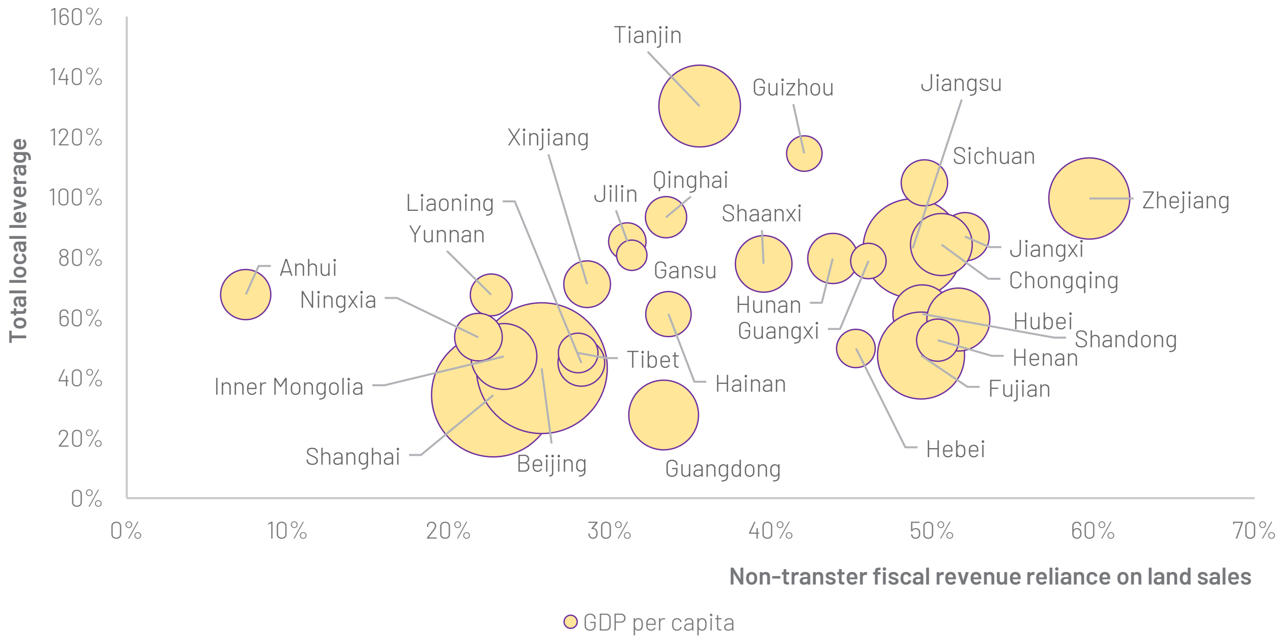
According to the central government's statement that provincial governments bear the ultimate responsibility for the insolvency of LGFVs within their territories[13], LRGs have further incentive to bail out troubled LGFVs. That said, LRGs' willingness to maintain the credibility of subordinate investment platforms depends on their fiscal strength and availability of local public resources, including local SOEs, and financial resources from local institutions, especially state-owned banks. Facing the soft property and land market, local governments in the different regions have varied fiscal capacity for making timely payments to subordinate LGFVs, and for mobilising resources to support distressed platforms; this has become the differentiating factor of credit performance among LGFVs.

The decision facing regions: favour the rich

LGFVs' creditworthiness was questioned amid the sluggish property and land market, as credit events started to reveal. The deterioration in LGFVs' credit conditions is more pronounced in underdeveloped regions, where LRGs have less tax revenue and are more reliant on land concessions, which led to more fragile fiscal structures susceptible to the property market downturn. Many LRGs relying more on land sales also carried high leverage, which made them overly stretched when allocating budgetary resources to subordinate LGFVs. There was also a large difference in availability of other public resources that could be deployed to support local platforms between LRGs in wealthy regions and those in less developed areas. With less mature cash-generating assets, fewer robust local SOEs held by LRGs that could be injected into subordinate LGFVs and fewer local financial resources to bolster the funding, LGFVs in economically weak areas are facing more pressure than peers in wealthy regions.

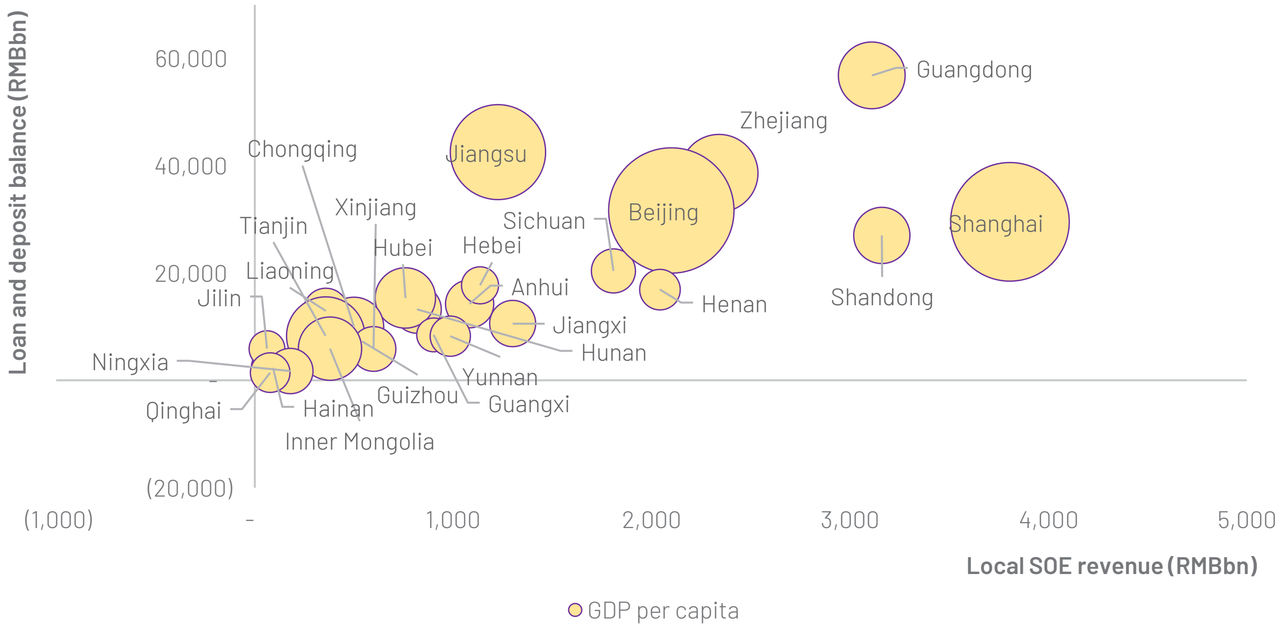
13. 13 June 2022, China government (https://www.gov.cn/zhengce/content/2022-06/13/content_5695477.htm)

Chart 18. Leverage, fiscal reliance on land sales and economic strength of provinces (as of December 2022)



Source: FinChina, Wind, Acuity Knowledge Partners

Chart 19. Comparison of size and financial-market depth of local SOEs in provinces (as of December 2022)



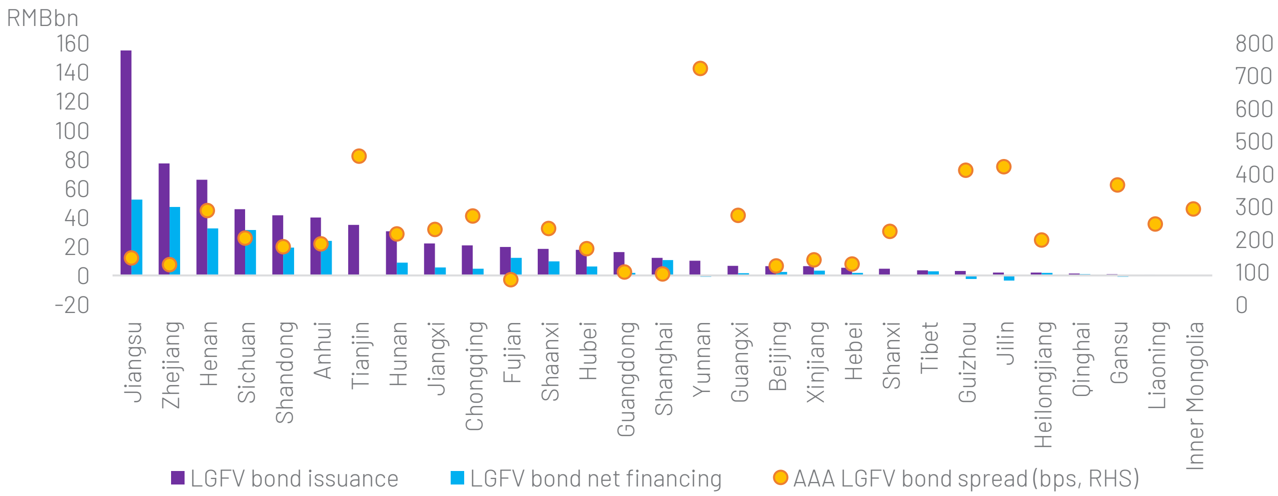
Source: FinChina, Wind, Acuity Knowledge Partners

Investors do not intend to obscure their preference between regions. Bolstered by solid economic fundamentals and fiscal resilience, eastern-coast provinces, such as Jiangsu and Zhejiang, carry significantly more LGFV debt, although they continue to report large net financing inflow and the lowest spread. With interest rates in China being cut because the economic recovery was slower than expected, institutional fixed income investors are under significant pressure when allocating assets. To achieve higher yield, investors either lengthen duration or lower the investment threshold for credit quality. This leads them to pursue bonds issued by LGFVs under lower-level governments, such as in districts or counties, in wealthy regions that had more predictable government support for subordinate platforms. Due to such market selection, Jiangsu and Zhejiang bear the most district- and county-level

LGFV debt. LGFV bond supply from southern-coast provinces with economic development as strong as that of eastern-coast peers', such as Guangdong and Fujian, is limited.

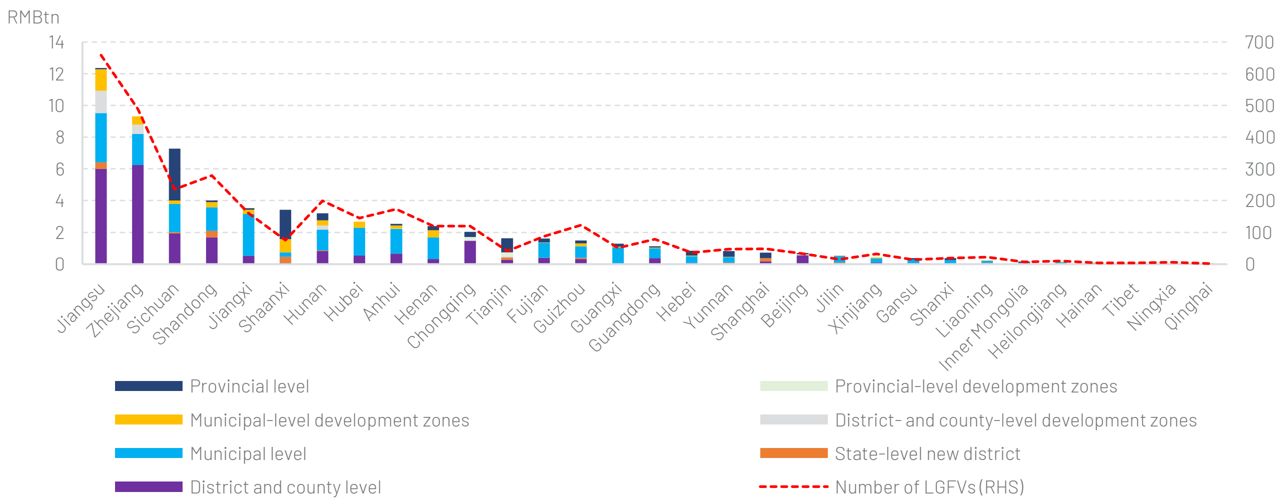
This is because they either have abundant tax resources and deep local financial markets or performed less aggressively in city development, leaving investors with fewer choices. Central and western provinces along the Yangtze River Economic Belt, including Sichuan, Chongqing, Hunan, Hubei and Anhui, were not as strong as coastal provinces in terms of economic development, with unequal in-province development between capital cities and other prefecture-level cities. However, owing to their regional status or not having excessive local leverage, platforms from these areas still maintain access to the capital market with a moderate level of bond spread, in line with the regions' higher risk profiles. Credit risks were exposed in a few sub-areas in these provinces, due to high local leverage and imbalanced debt product structure, but the impact on the entire province's financing condition was manageable. In contrast, economically weak areas, namely provinces in the northwest and southwest, and northeast China, saw spreads spike with limited net financing inflow, or even outflow, amid fiscal pressure and selective investor appetite.

Chart 20. LGFV bond supply, net financing and credit spread by province (as of December 2022)



Source: Wind, Acuity Knowledge Partners

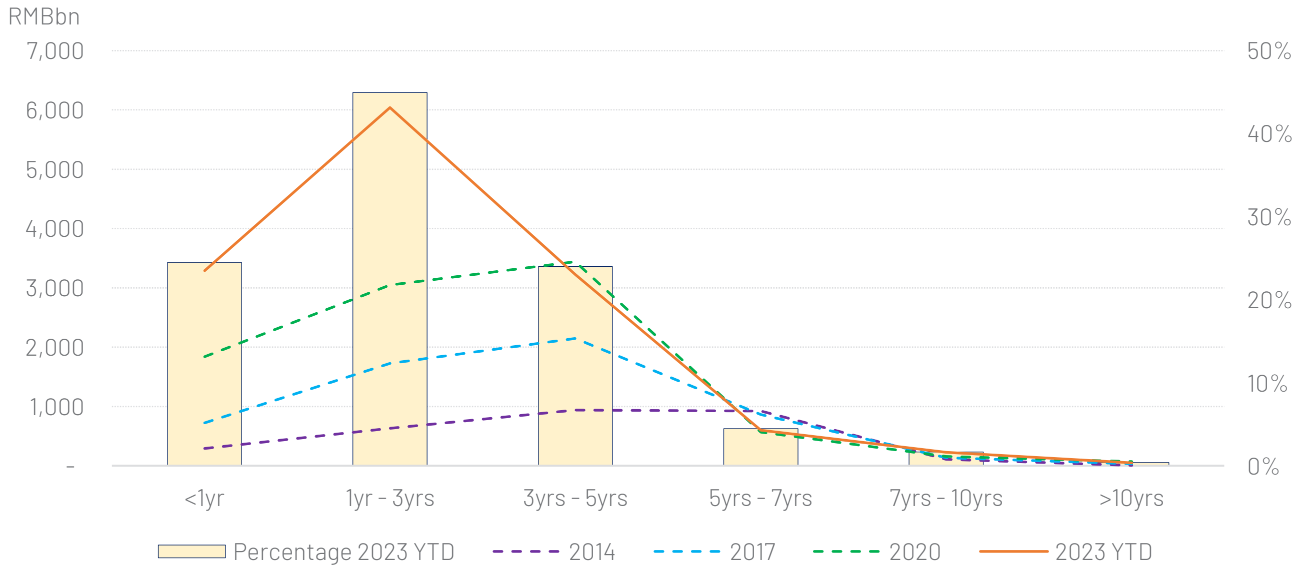
Chart 21. Outstanding LGFV bonds by level of government (as of December 2022)



Source: Wind, Acuity Knowledge Partners

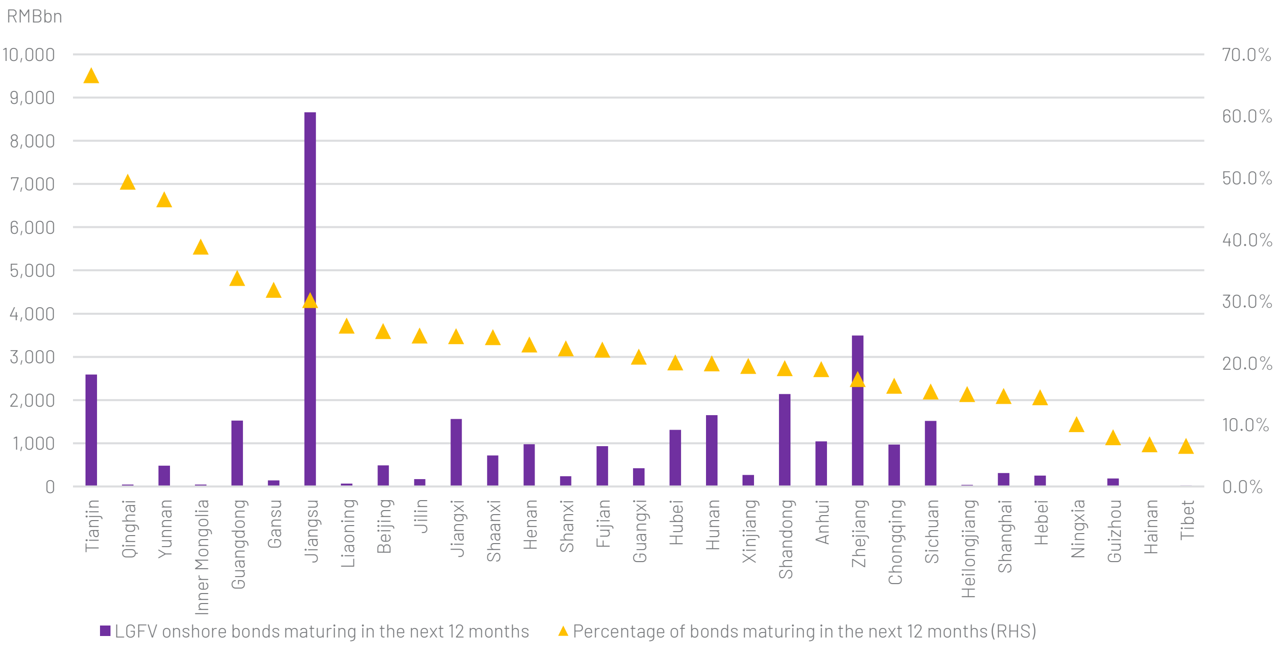
Refinancing pressure adds another layer of concern about LGFVs in different areas. LGFV bond issuance peaked twice in the past decade – in 2014-16 and 2019-20. The maturity structure of outstanding bonds has shifted towards the short end over the years. Aggravating the issue is the increasing reliance of LGFVs in economically weak areas on short-term (typically less than three years) bonds for refinancing, having opted out of long-term issuance due to a lack of market confidence. This has resulted in a large number of maturities in the next 12 months. The municipality of Tianjin had the largest number of these maturities as of July 2023, with 66.6% of its domestic LGFV bonds maturing in the next 12 months. Other economically weak provinces such as Qinghai, Yunnan, Inner Mongolia and Gansu face a similar challenge, with 30-50% of LGFV bonds maturing in the coming year. Jiangsu province has the most short-term maturities, but its high fiscal sufficiency and popularity among investors could help ease the maturity burden.

Chart 22. LGFVs' onshore bond maturity structure has shifted towards the short end (as of September 2023)



Source: Wind, Acuity Knowledge Partners

Chart 23. LGFV onshore bonds maturing in the next 12 months by province (as of July 2023)

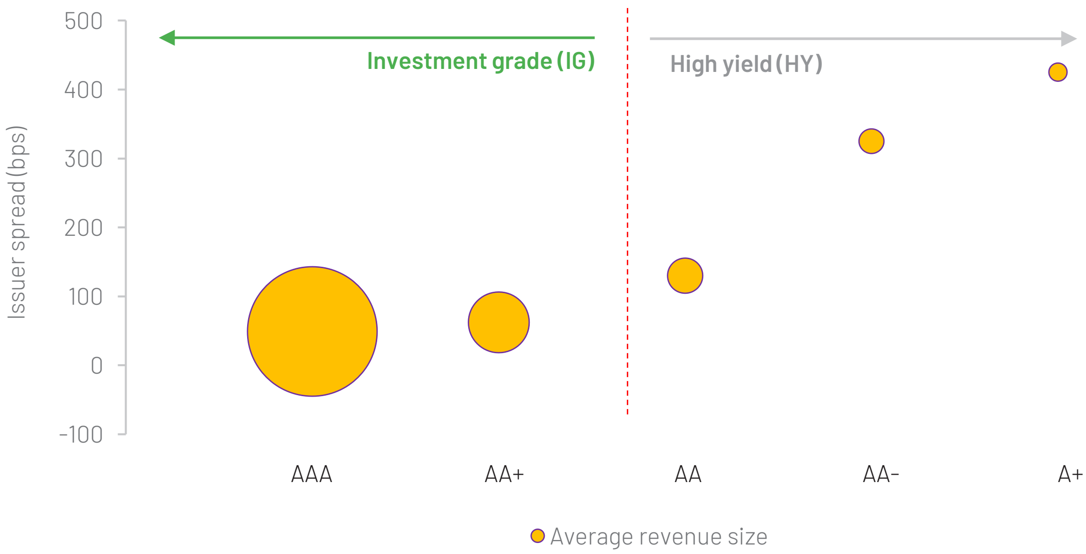


Source: Wind, Acuity Knowledge Partners

Diverging path of platforms: polarisation of credit performance

Credit performance also varies between entities from the same region. LGFVs' credit positions are determined by LGFVs' operating results and LRGs' extra support, both of which depend largely on local governments' fiscal or other public resources to make timely and full payment. LGFVs can be divided into provincial level, municipal level (city level) and district/county level, according to their LRG owners. The incentive for LRGs to maintain LGFVs' credit positions would, therefore, be determined by the platform's importance to the government. On one hand, this is decided by the LGFV's own characteristics, such as policy role, public-market exposure and recognition, and irreplaceability, and on the other hand, by the administrative status of the owner government, as a significant part of lower-tier governments' fiscal resources relies on a higher-level government's allocation or transfer payment. For example, the sole platform of a city's strategic development area would be more important than an LGFV in an outer-suburb county with several competing peers. The importance of platforms would also be revealed by the number and political implication of public projects undertaken. Larger platforms often undertake more public projects and tap more into capital markets, increasing their significance in local development and the local financing environment; therefore, they tend to enjoy increased resource allocation by local governments and higher credit ratings.

Chart 24. Revenue, ratings[14] and bond spreads of LGFVs



Source: Wind, Acuity Knowledge Partners

For example, Chengdu City, the provincial capital of Sichuan province, is far ahead of other prefecture-level cities in terms of city development and political importance. It has a state-level new economic area – Tianfu New Area – and a national high-tech industrial development zone – Chengdu Hi-Tech Industrial Development Zone. In Chengdu alone, there are 62 LGFVs assessed by S&P China, with different administrative levels, including city, district and county level, and platforms for economic zones. With such a large number of local LGFVs, the Chengdu government's support to the subordinate LGFVs varied compared with that to other cities in Sichuan province. While platforms belonging to the municipal level, key economic zones and core urban districts received high ratings, platforms in suburban areas faced far more tail risk and less government support. Other prefecture-level cities in Sichuan have far fewer LGFVs (from one to eight platforms assessed by S&P China), and these platforms would, therefore, have a higher likelihood of receiving support from local owner governments.

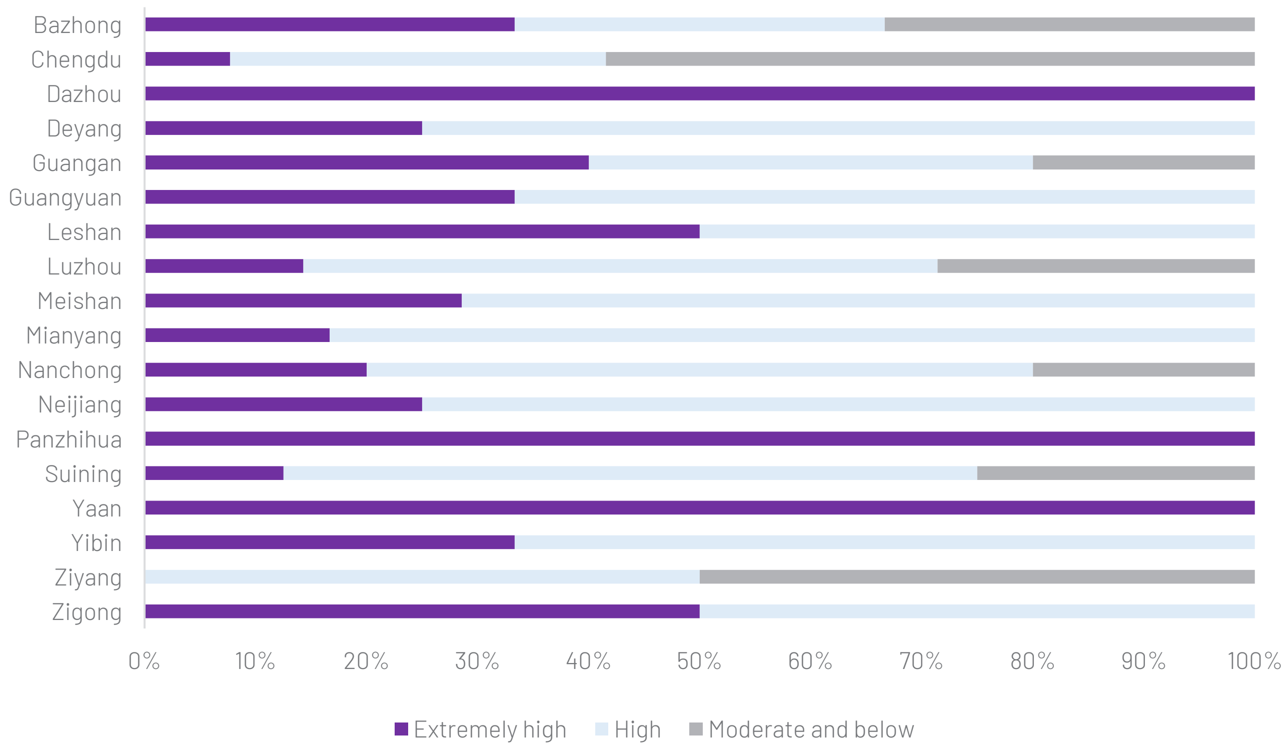
14. Issuers rated below AA (includes domestic rating) are considered to be high-yield names

Table 1. Ratings of LGFVs in Chengdu

Number of assessed LGFVs in each rating category		AA spc	A spc	BBB spc	BB spc	B spc
City level	Chengdu	2				
Key economic zone	Tianfu New Area		1			
	Chengdu Hi-Tech Industrial Development Zone		1			
Main urban districts	Chenghua District			5		
	Wuhou District			2		
	Jinniu District			3		
	Jinjiang District			2		
	Qingyang District			1		
Districts	Shuangliu District			2		
	Xindu District			2	2	
	Wenjiang District			1	4	
	Longquanyi District			2		
	Pidu District			2	2	
	Qingbaijiang District				3	
Outer suburban districts and counties	Chongzhou county-level city				2	
	Pengzhou county-level city				1	
	Qionglai county-level city				3	
	Xinjin District				3	
	Jianyang county-level city				6	
	Pujiang County				1	
	Jintang County				2	5
	Dujiangyan county-level city					2

Note: Used S&P's China-specific rating to increase rating differentiability; Source: S&P China Ratings

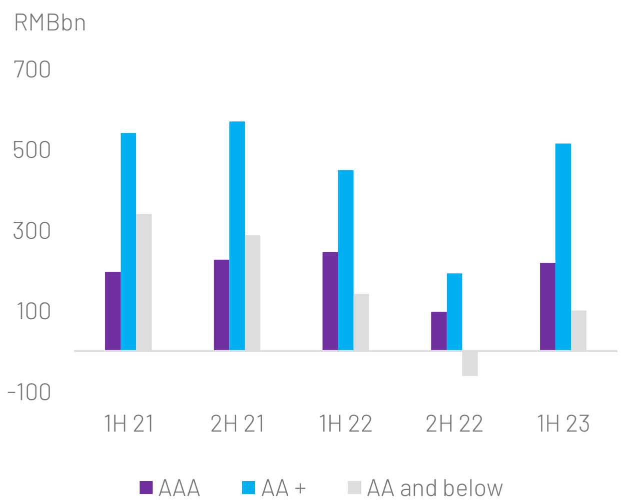
Chart 25. Level of government support to LGFVs in Sichuan province



Source: S&P China Ratings

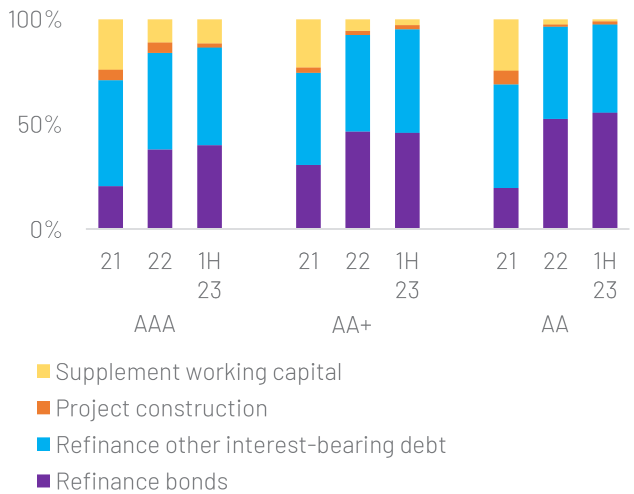
For example, Chengdu City, the provincial capital of Sichuan province, is far ahead of other prefecture-level cities in terms of city development and political importance. It has a state-level new economic area – Tianfu New Area – and a national high-tech industrial development zone – Chengdu Hi-Tech Industrial Development Zone. In Chengdu alone, there are 62 LGFVs assessed by S&P China, with different administrative levels, including city, district and county level, and platforms for economic zones. With such a large number of local LGFVs, the Chengdu government's support to the subordinate LGFVs varied compared with that to other cities in Sichuan province. While platforms belonging to the municipal level, key economic zones and core urban districts received high ratings, platforms in suburban areas faced far more tail risk and less government support. Other prefecture-level cities in Sichuan have far fewer LGFVs (from one to eight platforms assessed by S&P China), and these platforms would, therefore, have a higher likelihood of receiving support from local owner governments.

Chart 26. LGFVs' net bond financing by rating



Source: Wind, Industrial Securities, Acuity Knowledge Partners

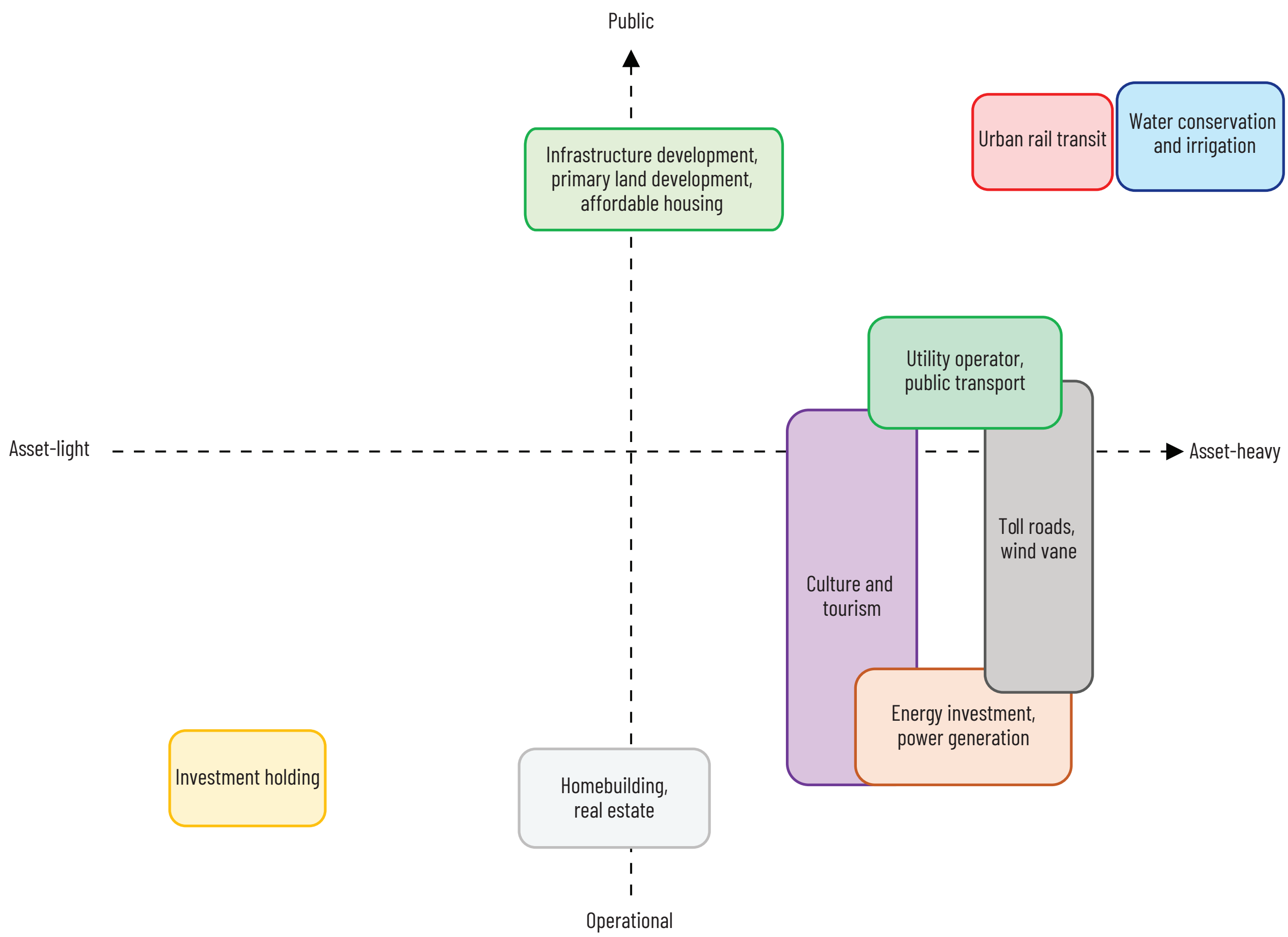
Chart 27. Use of proceeds of new LGFV issuance



LGFVs' business transformation also has credit implications. In response to the central government limiting local-government contingent liabilities, some LGFVs reduced reliance on fiscal revenue for cashflow, either by engaging in non-public projects or through LRGs injecting cash-generating assets. However, such transformation does not necessarily mean less of a connection between LGFVs and LRGs; in some instances, transformation is a way in which LGFVs can better fulfil their policy mandate in terms of city development and public projects. With more non-government revenue, LGFVs could access the capital market more easily, benefiting from compliance with regulatory requirements.

For example, except for exemptions, only LGFVs with less than 50% of their revenue from the government are allowed to issue corporate bonds (see Appendix), according to the Shanghai Stock Exchange. That said, with LGFV transformation progressing, we expect some platforms to take on fewer public roles. Some platforms engaged in areas such as power generation, holding SOEs and operating utilities, although a divergence from the traditional infrastructure development business, could still be important to LRGs for local economic development and stability, with the potential to receive considerable government support. Nonetheless, it would be appropriate to treat them the same as other operating SOEs, where the standalone operating performance determines credit assessment.

Chart 28. A map of platforms engaged in different businesses



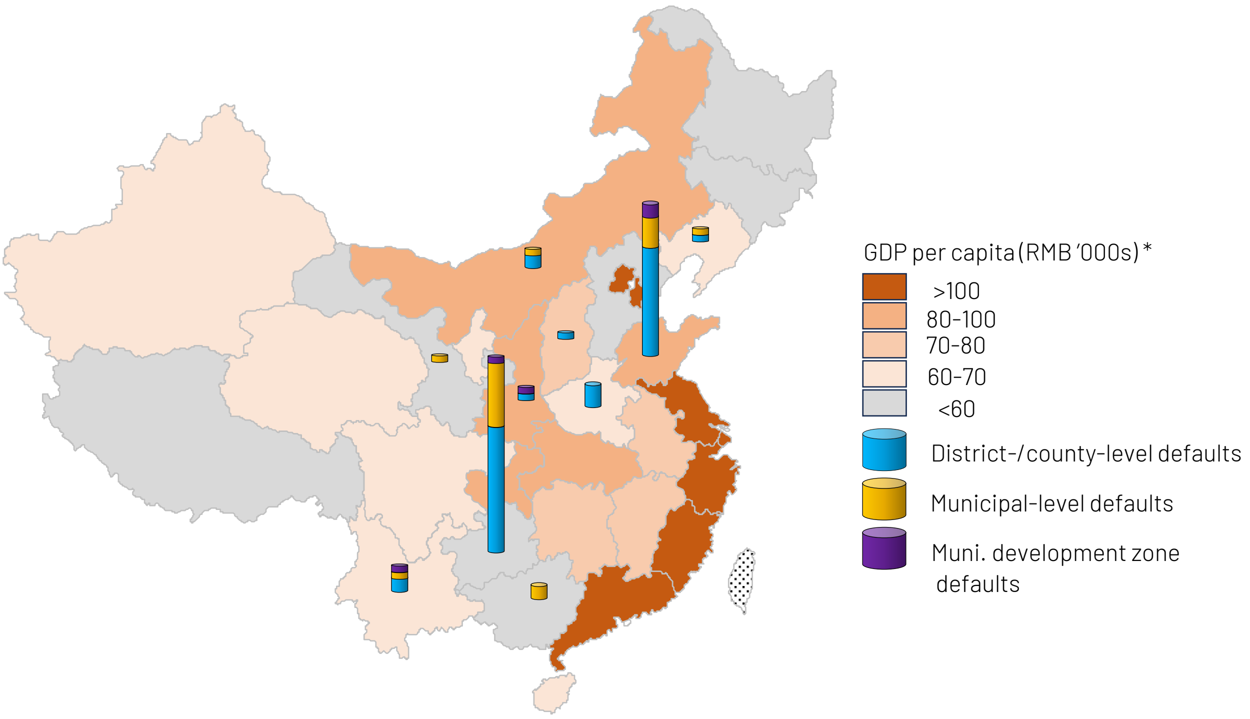
Source: Dealing Matrix, Acuity Knowledge Partners

It is not a directional credit wind vane for LGFVs undergoing transformation either. Although the change in business model aims to increase operational income and profit for LGFVs, the result could vary depending on operating capability and additional financial risk taken along the way. While some LGFVs obtained operating assets through LRGs' asset injection at zero cost, some LGFVs have to bear debt to finance investments and acquisitions needed for transformation; this could increase leverage and financial risk. As LGFVs' transformation continues to evolve, their role in policy projects may differ, requiring a shift in the analytical approach according to their essential risk exposure, but it would not be the sole basis for making a judgment call on the change in credit position.

Public debt vs non-standard instruments: the salvaged and the sacrificed

LGFVs and LRGs have been tenacious in repaying public debt, not wanting to take the risk and consequences of a public default of a local platform. A default in public issuance by an LGFV could be devastating to the local government's reputation, and the effect could be contagious, triggering risk aversion towards credit products from local SOEs, not only LGFVs, from that region. With growing financial pressure due to the decline in fiscal revenue and funding capacity, especially for lower-rated LGFVs, servicing public debt came at the cost of rising credit risk for non-public products. A total of 61 defaults on LGFV non-standard debt products were reported from 2021 to August 2023.

Chart 29. Non-standard LGFV debt default cases by province (2021 to August 2023)



*GDP per capita range includes upper bond, data as of December 2022; Source: FinChina, Acuity Knowledge Partners

Table 2. Regulatory risk of non-standard debt instruments

Source of fund	Examples	Degree of non-compliance risk against regulatory guidance
Bank credit	Bank-trust channel, bank-securities firm/fund – trust/bank channel	Extremely high
Trust scheme	Financing-type trust loans	Very high
	Brokerage asset management	Higher
Private equity asset management scheme	Fund asset management	Higher
	Futures asset management	Extremely high
Private equity fund	-	Higher
Financial lease	-	Lower

Source of fund	Examples	Degree of non-compliance risk against regulatory guidance
Direct financing through bank wealth management products	-	Very low
Debt products appear as equity investment	Collaboration with policy investment institutions, such as funds originated by China Development Bank (CDB) or Agricultural Development Bank of China (ADBC)	Extremely low
	Nominal equity but debt-nature products in other cases	Very high
Debt-financing scheme of the Beijing Financial Assets Exchange	-	Very low
Debt investment scheme of the Shanghai Insurance Exchange	-	Very low

Source: CSCI Pengyuan, Acuity Knowledge Partners

Chart 30. Non-standard LGFV debt by source of funding (RMBbn)

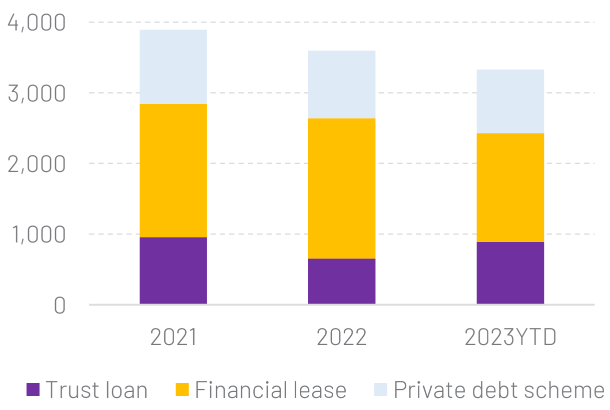
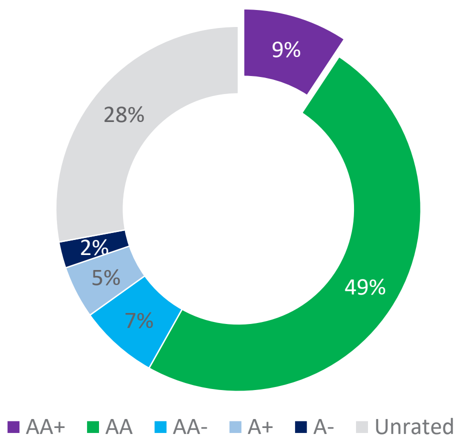


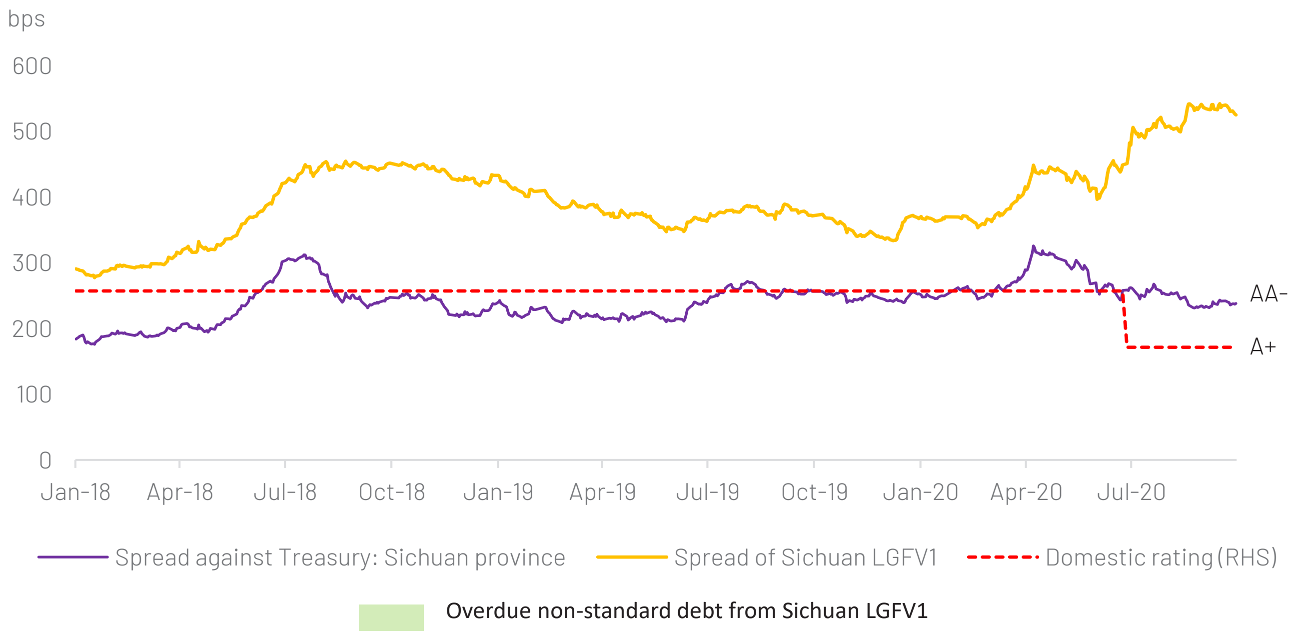
Chart 31. Defaults on non-standard LGFV debt by rating (2021 to August 2023)

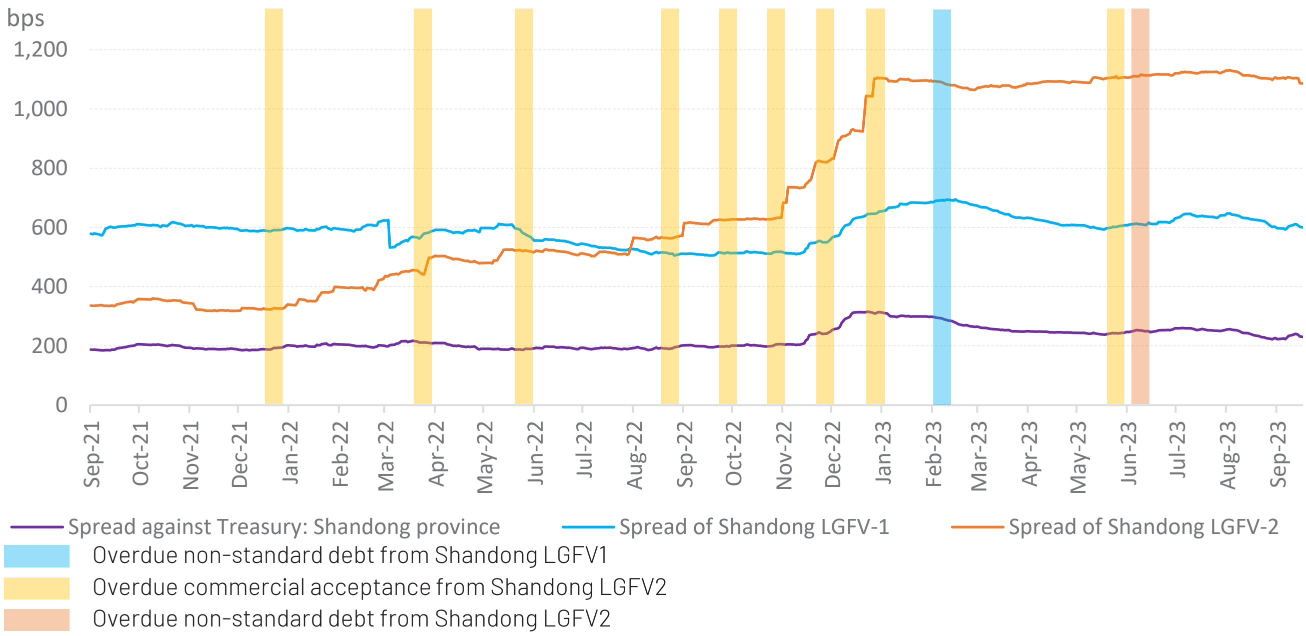


Source: FinChina, Wind, Acuity Knowledge Partners

Due to the private nature of non-standard debt instruments, the capital market and domestic rating agencies responded slowly to credit events relating to non-standard instruments. There was hardly a timely rating downgrade when non-standard defaults occurred, and LGFVs' credit spreads reacted slowly and only to a moderate degree, unless there were a number of overdue cases (see examples in Chart 31). The insensitivity of public participants, coupled with LGFVs' and LRGs' willingness to uphold credit performance in the public market, created a "pecking order" between public issuances and non-standard instruments. Troubled platforms would allocate financial resources primarily to public bonds and leave non-standard products at greater risk. The difference in risk to public debt and non-standard instruments could amplify, as the government may use defaults on non-standard products as a strategy to digest local high-cost contingent liabilities.

Chart 32. Examples of the public market's slow reaction to LGFVs' non-standard credit events





Source: FinChina, Acuity Knowledge Partners

As weak LGFVs found it difficult to find funding through the public market, their reliance on non-standard products increased; the reverse logic also holds – more use of non-standard products could be deemed as an early indicator of an LGFV's deteriorating credit condition. The time lag between the emergence of non-standard product credit events and potential market reaction leaves decent room for investors to adjust the portfolio.

Conclusion

Owing to their policy mandates and unique role in public projects, which generally comes with limited commercial profit and cashflow, LGFVs have a close relationship with LRGs and rely on fiscal resources to fund their investment activity in urban infrastructure development. When local governments faced a slowdown in the property market amid the central government's policy task of containing local-government contingent liabilities, LGFVs started to see squeezed operating inflow and funding conditions, leading to the surge in non-standard LGFV debt products. The public market also has to re-examine its confidence in LGFVs.

The central government is tasked not only with solving the problems associated with local governments' contingent liabilities and containing the increase in government-related LGFV debt, but also with "not inducing a systemic crisis" in its efforts to achieve policy goals. China's central government is unlikely to be aggressive in handling the burden of contingent debt. It values financial stability more than a quick deleveraging of local-government contingent liabilities, which would lead to large number of defaults in LGFV debt. Unconfirmed press reports indicated on 11 August 2023 that the central government plans to release a RMB1tn refinancing quota to local governments whose proceeds can be used to repay LGFV debt . Later in the same month, the minutes of the fifth meeting of the Standing Committee of the National People's Congress stated that the central government was contemplating a "whole package" debt relief plan . Confidence in LGFVs seems to be building due to the central government's prudent approach to dealing with potential systemic threats and the belief that the refinancing quota would lead to significant liquidity-related relief for LRGs and their subordinate LGFVs. Although such moves by the government have boosted market sentiment in the short term, it could entail risks that LGFVs may continue to build up debt, hoping that the central government would eventually bail them out at the end of the day. Policy aimed at reducing pressure on the sector would not preclude an LGFV default in the future; after all, it is also up to the central government to determine whether a particular LGFV default could trigger a sector-wide crisis before bailing it out.

Local governments are under pressure, both from the need for economic development and from political tasks assigned by the central government, especially as the central government stipulates that LRGs are responsible for debt risks within their territories. Although LRGs need to maintain the credibility of the platforms under their administration, local fiscal strength and other public resources that LRGs can use are sometimes limited and create a bottleneck.

With the deteriorating credit performance of LGFVs, confidence in them has plummeted. LGFVs should not be viewed as a whole, as their credit conditions vary, depending on the strength of owner governments and the LGFVs' importance to LRGs. With many LGFVs undergoing business transformation, the analysis approach could change, but without a direct impact on credit performance. Amid governments' fear of contagion risk and the relaxation of property-market policies, LGFVs could find some respite and weather the market's diminishing "faith in LGFVs". We note, however, that the strength of public bonds issued by local platforms was built on the failure of non-standard products.

Appendix

Regulatory requirements for LGFV bond financing across bond-financing instruments

<table>
<tr><th>Debt instrument</th><th>Enterprise bonds</th><th>Corporate bonds</th><th>Interbank debt-financing instruments</th></tr>
<tr><td>Regulatory body</td><td>Enterprise bonds</td><td>Extremely high</td><td>Extremely high</td></tr>
<tr><td>Identification of LGFV issuer</td><td>National Development and Reform Commission (NDRC)</td><td>Very high</td><td>Very high</td></tr>
<tr><td rowspan="2">Rating requirement</td><td rowspan="2">Issuers with issuer rating above AA (include) and issue rating above AA+ (include) are allowed to use <=40% of raised proceeds in working capital supplementation and repayment of bank loans</td><td>Offering to public investors/ offering to qualified investors:
AAA</td><td rowspan="2">Issuer rating above AA (include)</td></tr>
<tr><td>Non-public: at issuer’s discretion</td></tr>
<tr><td>Company size</td><td>Net assets >RMB1.2bn; if net assets <RMB1.2bn, issue through joint bond</td><td>Joint-stock company: net assets >=RMB30m, limited liability company: net assets >=RMB60m</td><td>Total assets >=RMB5bn, net assets >=RMB2.5bn</td></tr>
<tr><td rowspan="4">Administrative hierarchy consideration</td><td>Provincial capital cities: up to two platforms allowed to issue enterprise bond</td><td rowspan="4">N/A</td><td>Platforms owned by governments above prefecture-level cities (include): allowed</td></tr>
<tr><td>National-level development zone and free trade zone, prefecture-level cities: up to one platform</td><td>District- and county-level LGFVs under provincial capitals and cities with separate plans: allowed</td></tr>
<tr><td>Top 100 counties: up to one1 platform</td><td>Other district- and county-level platforms: can only issue bond with UOP in farmland water conservancy, comprehensive pipeline corridors, sponge cities, rail transport and affordable housing</td></tr>
<tr><td>Districts of municipalities directly under the central government: up to one platform</td><td>Local government with either <=100% debt to fiscal strength or <=60% debt to GDP: no limitation on administrative level</td></tr>
<tr><td rowspan="3">Restriction on local leverage or fiscal reliance</td><td>Total local government debt ratio (audited by the National Audit Office) where LGFVs reside <=100%</td><td rowspan="3">The share of revenue from the local government where the company resides <=50%</td><td rowspan="2">Local leverage <=150%</td></tr>
<tr><td>Government receivables <=60% net assets for issuers rated AA and above, and <=40% for AA- and below</td></tr>
<tr><td>Operating profit contributes >=70% of debt service, funds from BT contracts and returning of land premium in the specified areas are not allowed to be used as the source of debt service</td><td><=3 high-risk flags in the risk warning system (constituted by debt ratio of general and special debt, debt growth of general and special debt, debt principal payment to fiscal expenditure of general and special debt, overdue debt ratio of general and special debt, and weighted average of above-risk ratio)</td></tr>
</table>

Debt instrument	Enterprise bonds	Corporate bonds	Interbank debt-financing instruments
Other restrictive requirements	Investment project for fundraising should not be pure public welfare projects	Issuance should not incur incremental government debt	Existence of operating assets
	Track record of credit events in government-related debt or liabilities	Use of proceeds of corporate bond issued through private placement exceeding 40% of the company's net assets is constrained in refinancing	Presence of defined and reliable debt-service plan
	Outstanding amount of enterprise bond and MTN >8% of local GDP	-	-
	Other events that may impact regional financial and social stability	-	-

Source: NDRC, CSRC, NAFMII, Financial Regulation & Law

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