Regional and Local Governments - China

2017 Outlook – High Leverage of State-owned Enterprises Drives Negative Outlook

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2017 Chinese Regional and Local Government Outlook - Negative

- Significant deleveraging by RLGs’ heavily-indebted state-owned enterprises (SOEs) will take time
- Continuing slowdown of China’s GDP growth will hold back RLG revenues and land sales
- Policy changes could cause uncertainty

What could change outlook to stable:

- Significant deleveraging of RLG-owned SOEs, accompanied by improved performance of SOE assets
- Economic stabilization, underpinning RLG revenue growth and China’s real estate market
- Greater certainty on the direction of policy changes

Note: A negative sector outlook indicates our view that fundamental fiscal and economic conditions will worsen. A positive outlook indicates that we expect fundamental fiscal and economic conditions to improve. A stable outlook indicates that conditions are not expected to change significantly. Since outlooks represent our forward looking view on conditions that factor into ratings, a negative (positive) outlook indicates that negative (positive) rating actions are more likely on average.
2017 Chinese RLG Outlook - Negative

Key credit themes

» High SOE leverage pressures RLG credit quality
» SOE deleveraging will take time
» GDP growth fell for 25 of 30 provinces in Jan-Sept 2016
» China GDP growth likely to continue slowing gradually
» Weaker GDP growth will hinder RLG revenue growth
» Land sales add volatility to RLG revenues
» Policy changes could cause uncertainty
High SOE Leverage Pressures RLG Credit Quality

» The liabilities of more than 100,000 RLG-owned SOEs, including local government financing vehicles (LGFVs), grew at an average annual rate of 14.1% in 2012-15, reaching RMB35.4 trillion ($5.1 billion)

» This amount was more than double the RLG sector’s total direct debt of RMB16.0 trillion; in most provinces, SOE liabilities exceeded combined RLG revenues

SOE liabilities are substantial relative to RLG revenue

Circle size denotes the relative magnitude of SOE net asset

Source: Ministry of Finance
SOE Deleveraging Will Take Some Time

» Local SOEs in overcapacity sectors – such as coal and steel – are under greater stress, and progress towards removal of excess capacity is uneven

» RLG support is much more likely for SOEs engaged in public policy delivery, such as LGFVs, than for those engaged in commercial activities; the regulatory environment will continue to evolve in a way that limits RLGs’ ability to support many of their SOEs

RLG responses to recent SOE credit-distress events

<table>
<thead>
<tr>
<th>RLG</th>
<th>SOE Name</th>
<th>SOE’s Main Business</th>
<th>Date</th>
<th>Event</th>
<th>RLG Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sichuan Province</td>
<td>Sichuan Coal Industry Group Co., Ltd.</td>
<td>Coal Mining</td>
<td>Jun-16</td>
<td>Late payment on commercial paper</td>
<td>Encouraged creditors to refinance</td>
</tr>
<tr>
<td>Chongqing Municipality</td>
<td>Chongqing Steel Group Co., Ltd.</td>
<td>Steel</td>
<td>Jun-16</td>
<td>Restructuring</td>
<td>Organizing a sale of steel assets to a stronger SOE</td>
</tr>
<tr>
<td>Tianjin Municipality</td>
<td>Bohai Steel Group Co., Ltd.</td>
<td>Steel</td>
<td>Apr-16</td>
<td>Distressed restructuring after missing payments on bank loans</td>
<td>Organizing debt-for-asset swap</td>
</tr>
<tr>
<td>Liaoning Province</td>
<td>Dongbei Special Steel Group Co., Ltd.</td>
<td>Specialty Steel</td>
<td>Mar-16</td>
<td>Insolvency restructuring after missing payments on multiple bonds</td>
<td>No specific support</td>
</tr>
<tr>
<td>Guangxi Province</td>
<td>Guangxi Non-Ferrous Metals Group Co., Ltd.</td>
<td>Non-Ferrous Metals</td>
<td>Dec-15</td>
<td>Liquidation after missing payments on private placement notes</td>
<td>No specific support materialized</td>
</tr>
<tr>
<td>Heilongjiang Province</td>
<td>Longmay Mining Holding Group Co., Ltd.</td>
<td>Coal Mining</td>
<td>Dec-15</td>
<td>Arrears on wages and benefits</td>
<td>Disbursed early fiscal subsidies and provided a bridge loan</td>
</tr>
<tr>
<td>Yunnan Province</td>
<td>Yunnan Coal Chemical Industry Group Co., Ltd.</td>
<td>Coal &amp; Chemical</td>
<td>Oct-15</td>
<td>Distressed restructuring after missing payments on bank and trust loans</td>
<td>Asked the provincial SOE capital management company to assume outstanding bonds</td>
</tr>
</tbody>
</table>

Source: bonds disclosure documents, creditor committees’ announcements, companies’ websites, Shanghai Clearing House, WIND
GDP Growth Fell for 25 of 30 Provinces in Jan-Sept 2016

Only five provinces had stronger GDP growth in Jan-Sept 2016

Source: Provincial Statistics Departments
Note: Tibet is not included due to limitation on data
China GDP Growth Likely to Continue Slowing Gradually

Slowing growth trend for GDP

Source: National Bureau of Statistics and Moody's
Single-digit growth of revenues likely to continue

Source: Ministry of Finance
Land Sales Add Volatility to RLG Revenues

» RLGs’ high dependence on volatile land sales for revenue is a credit weakness

» RLG efforts to increase property tax receipts, a more stable revenue source, are hindered by the lack of a property registration system

Land sale revenues are volatile

Source: Ministry of Finance
Policy Changes Could Cause Uncertainty

» SOE deleveraging reforms moving to guideline stage; effective implementation will require further institutional and legal measures.

» LGFVs remain the main source of infrastructure investment for now, increasing RLGs’ contingent liabilities.

» Ongoing fiscal reforms include an overhaul of RLGs’ accounting and financial disclosure standards and are designed to make them more transparent, including the introduction of an accrual basis financial reporting system, and a plan to reform the intra-governmental fiscal framework.

» In particular, the guideline on RLG debt contingency planning (Document 88), issued in November 2016 underscores the central government’s intention to address RLG debt risks through enhanced reporting and supervision of RLGs, and by establishing contingent plans.

» If the new reporting system effectively reduces moral hazard, it will be credit positive for RLGs because it will encourage greater fiscal discipline, and hence reduce the risk that localized contingent liabilities crystallize. However, the guideline also outlines that, in the case of systemic crisis, government support remains, and with it broader contingent liability risks for RLGs.
Global Credit Conditions Remain Uneven, Despite Stabilizing Growth

A modest revival in global growth and sustained low interest rates provide a reasonably stable backdrop for global credit in 2017, and we do not foresee a major spike in defaults. However, nine years after the global financial crisis, the world economy is still meandering along a path of disappointing growth. And there are a number of challenges – notably, concerns over the efficacy of monetary policy, a busy election calendar in Europe and the policy implications of Donald Trump’s election as US president – which will translate into more uncertain economic and credit outcomes over the coming year.

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