

China's Revised Corporate Bond Rules May Increase Risks For Lower-Tier LGFVs

Primary Credit Analyst:

Gloria Lu, CFA, FRM, Hong Kong (852) 2533-3596; gloria.lu@spglobal.com

Primary Contact:

Laura C Li, CFA, Beijing (86) 10-6569-2930; laura.li@spglobal.com

HONG KONG (S&P Global Ratings) Sept. 8, 2016--The financing vehicles (LGFVs) of China's lower-tier local governments could face increased refinancing and policy risks following recently revised regulations. The Shanghai Stock Exchange has stipulated that LGFVs that generate more than half their revenue from local governments will no longer be allowed to issue corporate bonds. S&P Global Ratings believes the risks could particularly intensify for lower-tier vehicles if there's a liquidity crunch in the domestic bond market.

"Chinese LGFVs are highly reliant on banks and the domestic bond market to refinance their huge amount of debt maturities. Under the revised rules, therefore, some lower-tier LGFVs may no longer be able to secure an important funding source," said S&P Global Ratings credit analyst Gloria Lu.

However, for higher tiers, the increased threshold for corporate bond issuance will have a limited impact on refinancing. Corporate bonds traded in the exchange only account for less than 10% of the outstanding debt issuance of LGFVs as a whole.

"We believe the impact on large-scale and higher-tier LGFVs could be moderate because those LGFVs usually have sufficient banking facilities and diversified financing channels, and benefit from strong local government support and debt replacement," said Ms. Lu.

The new rules prohibit corporate bond issuance by LGFVs and companies that engage in land development and government-project construction and have derived more than 50% of their revenue from the local governments in the past

two to three years. Previously, LGFVs could still issue corporate bonds even if they breached the 50% revenue threshold, provided their cash flow from local governments was less than 50%.

The new rules would now affect those LGFVs that planned to raise funds through corporate bonds while undertaking significant government projects, if they breach the revenue threshold. Most LGFVs have issued domestic bonds through the National Association of Financial Market Institutional Investors (NAFMII) if they meet the 40% cap of issuance to net assets, along with other conditions. LGFVs with diversified businesses and cash flows typically have access to both the corporate bond and interbank markets.

In our opinion, Chinese regulators are attempting to contain the credit risks of issuers and at the same time balance this against the LGFVs' desire to secure better funding costs through increased market access. The government regards infrastructure investment led by LGFVs as an important engine for stable economic growth. NAFMII recently lifted its controls over the issuance of enterprise bonds in the interbank market by district- and county-level LGFVs. However, potential issuers still need to meet or exceed a required rating level. Many lower-tier LGFVs therefore may not benefit from the new rules.

Under the State Council's "No. 43 Article" outlined in late 2014, regulations and policy aim to gradually strip the government financing function from the LGFVs. In our view, this has heightened the policy risk for LGFVs.

China's economic slowdown has intensified the difficulties for industrial issuers that are experiencing overcapacity and weak demand, as indicated by more "credit events," such as defaults. However, investors continue to have higher confidence in issuers with government support, easing their access to credit. But LGFVs are still subject to refinancing and policy risks.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

S&P Global Ratings, part of S&P Global Inc. (NYSE: SPGI), is the world's leading provider of independent credit risk research. We publish more than a million credit ratings on debt issued by sovereign, municipal, corporate and financial sector entities. With over 1,400 credit analysts in 26 countries, and more than 150 years' experience of assessing credit risk, we offer a unique combination of global coverage and local insight. Our research and opinions about relative credit risk provide market participants with information that helps to support the growth of transparent, liquid debt markets worldwide.

Copyright © 2016 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.