China's Local Governments: Capacity To Support SOEs Will Be Tighter For Longer

Shrinking capacity to support SOE sector is forcing more selectiveness

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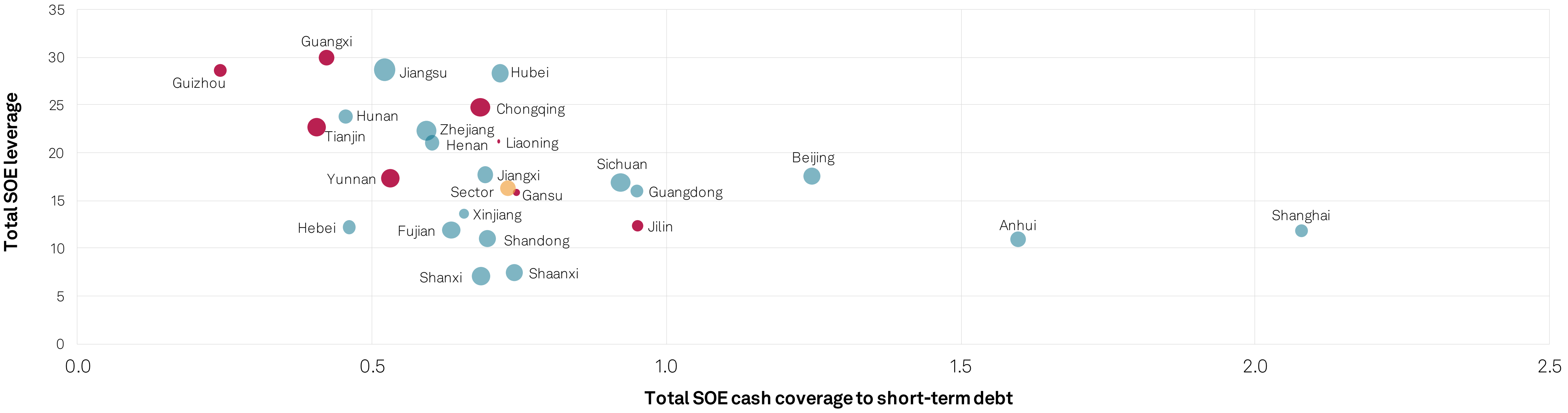
Key Takeaways

- Local and regional governments (LRGs) will deal with tight capacity for longer. This is due to a slow fix in their fiscal positions and no quick transition away from the debt-funded growth model for local state-owned enterprises (SOEs).
- As a result, the LRGs will likely differentiate support for SOEs when they must and keep allowing low-impact credit events to happen.
- When extended, support during stress will more likely be delivered through stronger local SOEs or by coordinating with banks and other capital providers to provide financing.
- “Low risk regions” are not immune--their SOE sector profiles are worsening faster, possibly because they have better funding access and growth commitment.
- Local debt de-risking measures such as LRG debt swaps and bank refinancing provide marginal benefits to LRGs' capacity to support their SOEs, in our view.
- Progressive improvements in LRG revenue could stop things from getting worse. Effective control of overall SOE sector debt growth, and improvements in profitability via better investment efficiency, would help reverse this trend.

Diverse SOE Profiles Differentiate LRGs' Capacity To Support The Sector

- Regional SOE profiles are diverse and mostly at weak levels.
- The SOE sector's debt size and creditworthiness are key factors for an LRGs capacity to support in times of stress.
- The most common way for China's LRGs to provide support to a stressed SOE is through other SOE(s), e.g., via bridge loans, or asset sales.

Provinces' SOEs display diverse sizes and credit profiles (whole province, 2023)

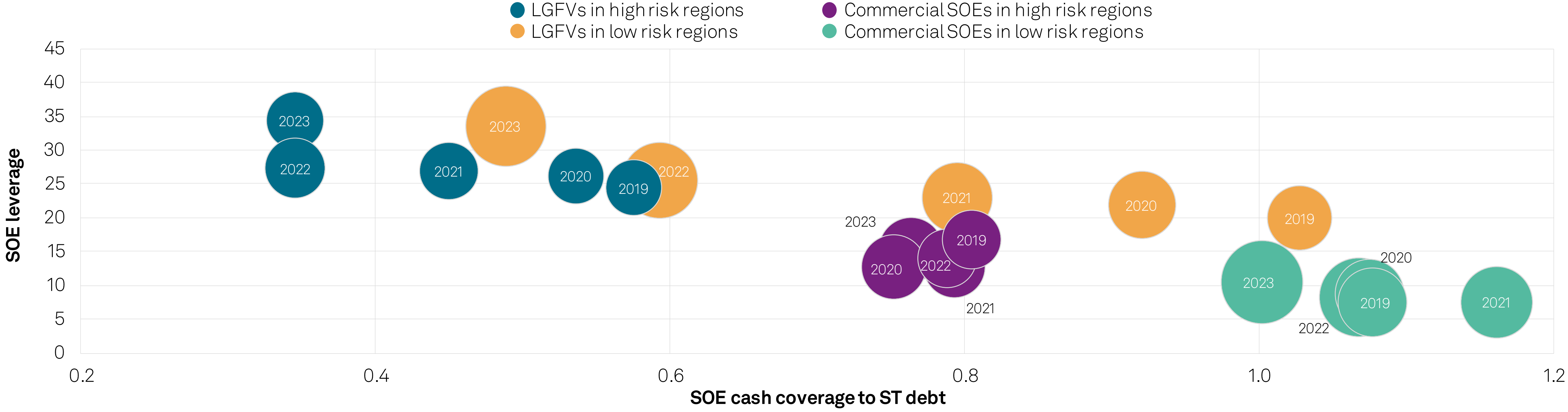


Bubble size indicates local SOE sector debt size. Yellow bubble -- whole sector. Red bubbles--"high risk regions" regarding indebtedness as mentioned by a State Council document in Dec 2023. See Glossary for definitions of measures. Inner Mongolia, Heilongjiang, Hainan, Tibet, Qinghai, and Ningxia are excluded from individual display due to small sample of SOEs with disclosure. Source: Wind, local governments' finance bureau websites, S&P Global Ratings.

SOE Sector Profiles Are Generally Deteriorating, LGFVs In Particular

- LRG capacity has become generally more burdened with rising SOE sector debt and leverage, and weakening cash coverage due to rising LGFV short-term debt.
- Profiles of SOEs in "low risk regions" are converging with those in "high risk regions", possibly because of better funding access and growth commitments.
- Commercial SOEs in general are faring better than LGFVs.

SOE sector profiles sliding in recent years (whole province, 2019-2023)

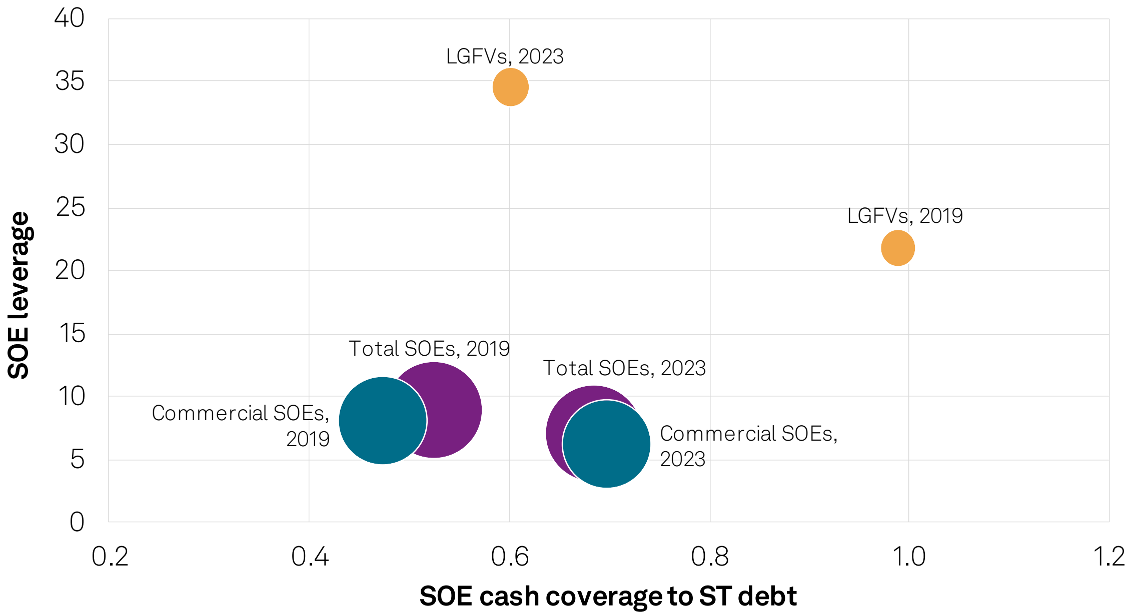


Low risk regions – mainland regions outside of 12 "high risk regions". Bubble size indicates local SOE sector debt size. See Glossary for definitions of measures. LGFVs as defined by Wind. Source: Wind, local governments' finance bureau websites, S&P Global Ratings.

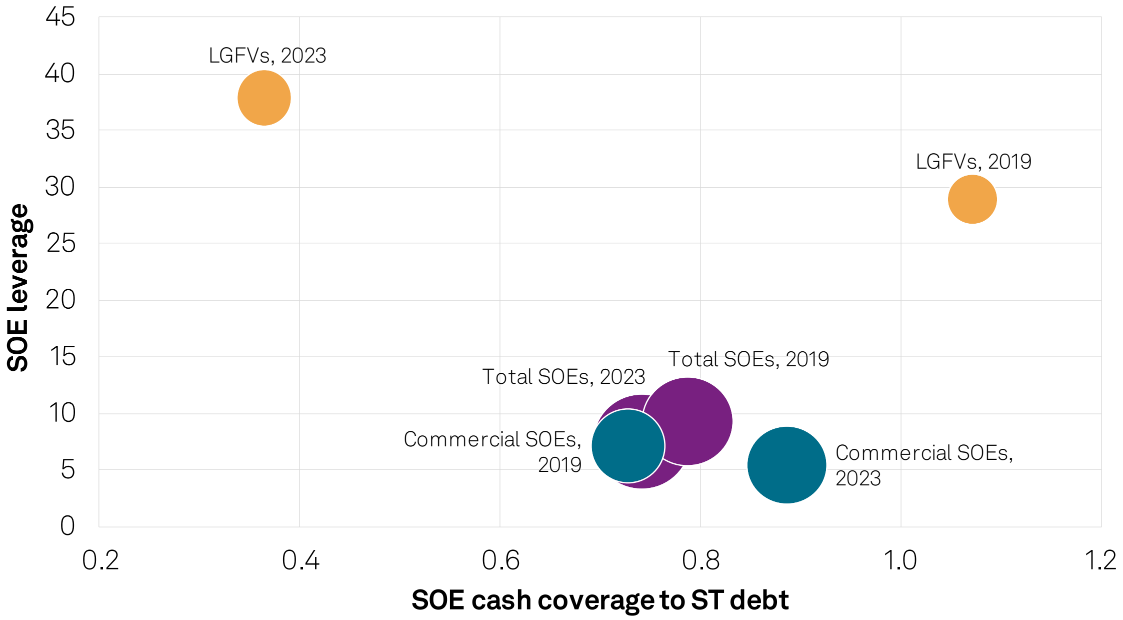
Few Outperformers

- Commercial SOEs could relieve the LRG capacity limitations, if they are sizable and performing well enough. Buoyant commodity prices seem to have benefited a few inland provinces as such.
- There are only a few improvers since 2019. In general, local SOEs' asset-liability ratio worsened to 63% in 2022 from 62.2% in 2019. The trend is persisting year to date and unlikely to reverse quickly.

Shanxi's commodity focused SOEs mitigate growing pressures



Likewise for Shaanxi due to benefits from commodity prices

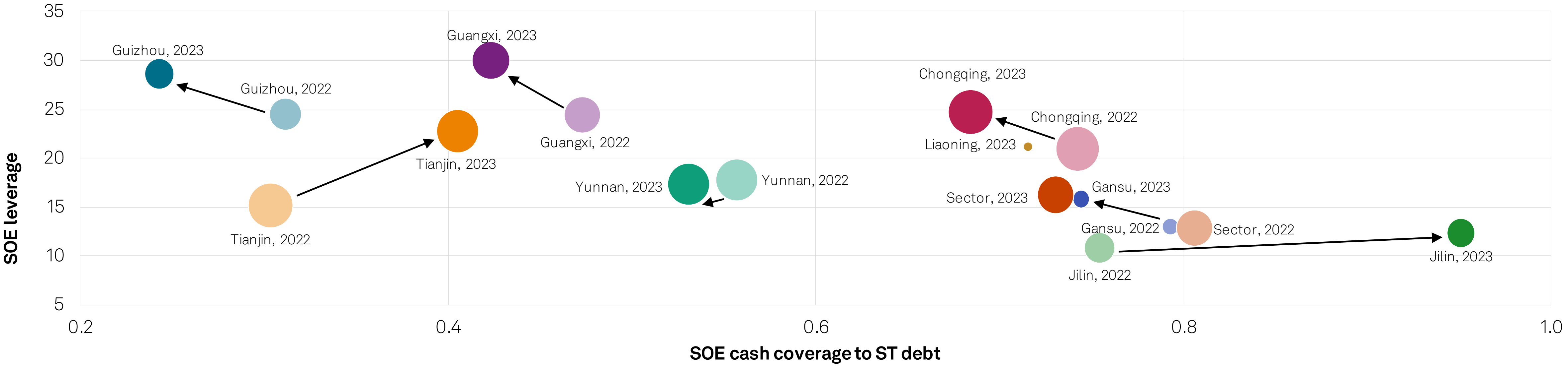


Bubble size indicates local SOE sector debt size. See Glossary for definitions of measures. LGFVs as defined by Wind. Source: Wind, local governments' finance bureau websites, S&P Global Ratings.

Recent Local Debt Derisking Measures – Will They Improve Capacity To Support?

- Measures such as reining in SOE debt growth, LRG debt swaps, and bank swaps may be more effective in slowing debt growth and reducing short-term maturity ratios. Improving profitability or genuine deleveraging are harder to achieve through policies.
- Eight out of 12 focused regions improved SOE sector debt size in 2023, but only three for sector leverage.
- Ten of 12 saw lower short-term debt as a % of total debt in 2023, leading to five improvers in sector cash coverage for short-term debt.

Local debt de-risking controls debt growth, but many of the focus regions still saw deterioration in SOE sector creditworthiness
(whole province, 2022 vs 2023)

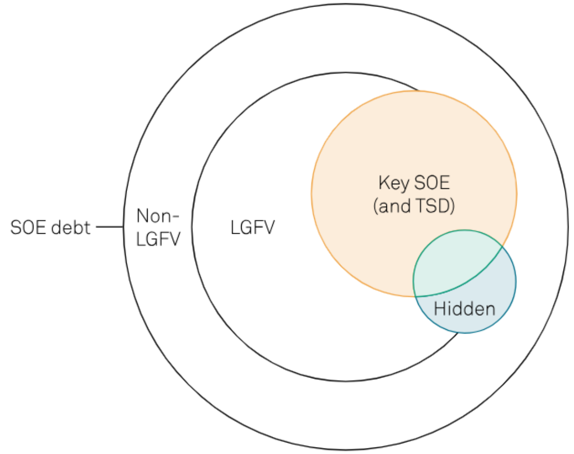


Inner Mongolia, Heilongjiang, Qinghai, Ningxia excluded due to small sample of SOEs with disclosure. Liaoning 2022 is not visible on chart with leverage at 88. Bubble size indicates local SOE sector debt size. See Glossary for definitions of measures. Source: Wind, local governments' finance bureau websites, S&P Global Ratings.

To Support Or Not To Support?

Selective support with weakened capacity

- LRGs have repayment responsibility for "hidden debt".
- ... and oversight responsibility for SOE sector to prevent high-impact credit events and potential spillover risks.
- Capacity weakening is leading to greater differentiation and discernment in support.
- ... and possible low impact risk events.

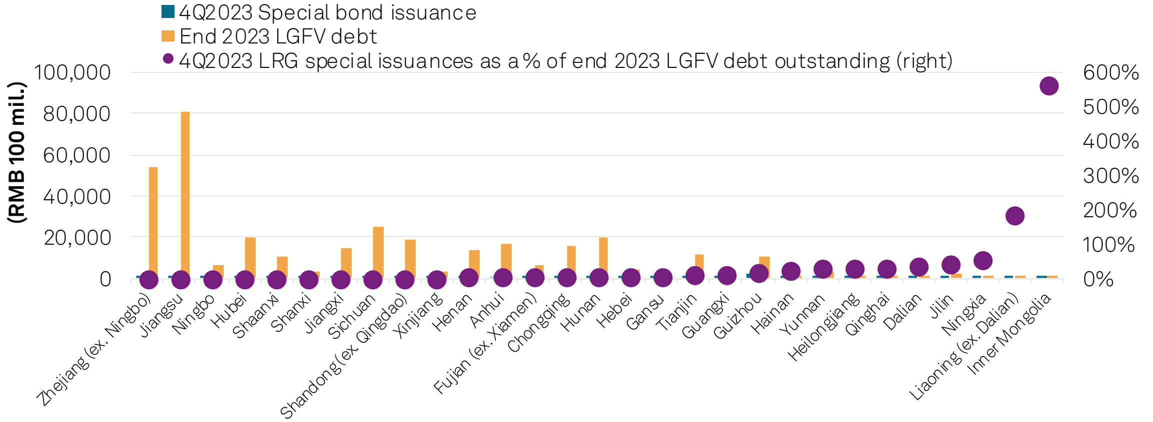


TSD--Tax supported debt. LGFV--Local government finance vehicles. SOE--State-owned enterprises.
Source: S&P Global Ratings.

How do LRGs provide support to stressed SOEs?

- Unlikely with fiscal resources, unless budgeted (e.g. capital injections) or related to hidden debt (debt swaps).
- More likely through other local SOEs (e.g. asset transfer, consolidation, capital injection, or liquidity bridges).
- At times via LRG-controlled banks (e.g. credit lines, restructuring).

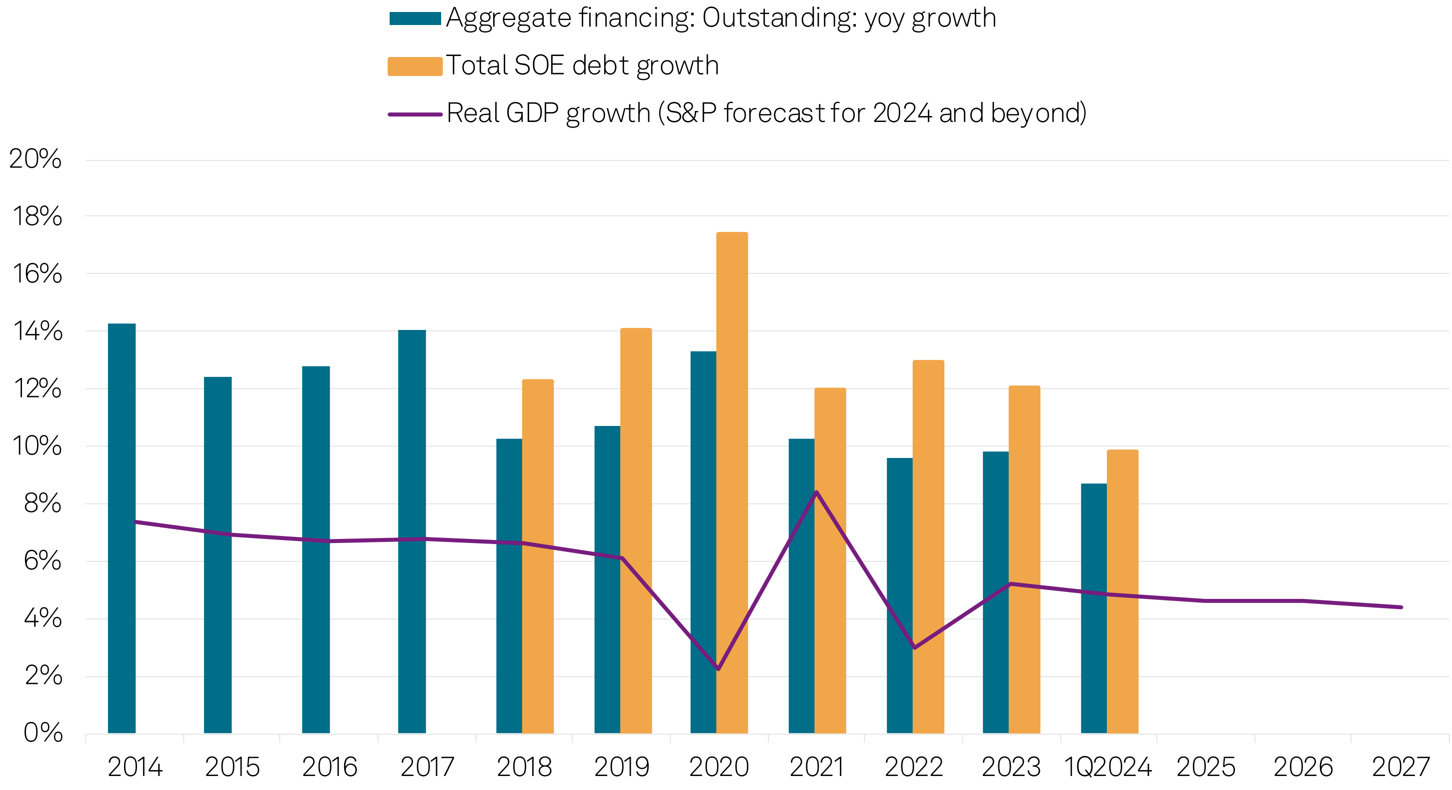
LRG special bonds alleviate pressure for selected regions



Sources: FinChina, Wind, S&P Global.

The Way Out For China's Local Debt Problems

Reining in debt growth and improving SOE profitability are key



Source: National Bureau of Statistics, People's Bank of China, Wind, S&P Global Rating.

- China's local public finances will gradually repair over the next few years, anchored by 4%-5% GDP growth and a stabilizing property sector over the period. We expect the central government to sustain strong support to local finances.
- Sustained efforts to rein in leverage should see slowing debt growth for local SOEs.
- An increasing focus on investment and financing efficiency would help improve SOE profitability and organically break from a debt-funded growth model.
- Policy derisking efforts could provide marginal relief only. The LRGs, SOEs, financial institutions and investors may need to share burdens until China can outgrow the problem.

Our Research Scope And Glossary

How we measure an LRG's capacity to support its SOE sector

Our analysis largely focuses on a government's capacity to support the debt of its GREs, and not a government's capacity to pay its own debt.

We identify three measures to gauge a government's capacity to support its SOE sector: SOE size, SOE creditworthiness, and LRG control over nonbudget resources. We focus on the former two factors in this study. Our analysis does not encompass the wider financial resources that LRGs can control. These funding options vary widely in their form and complexity and cannot be easily captured using simple metrics. With the central government's increasing scrutiny of LRGs' budget plans, LRGs will not be able to spend--including to provide excessive support to government-related entities (GREs)--unless such an activity were pre-approved in the budget.

The SOE sector's debt size and creditworthiness are suggestive of a local and regional government (LRG)'s capacity to support it. This is because in China, the most common way for LRGs to provide support to an SOE in stressed situations, is through other SOE(s). As such, the health of the local SOE sector is indicative of the resources at an LRGs' disposal.

We use the local SOE sector leverage and cash coverage for short-term debts as a proxy gauge for its creditworthiness.

Our metrics only refer to nonfinancial-institution SOEs. Our aggregated SOE data by province serve as a proxy to measure SOE risk of all tiers of LRGs, on a whole-province basis. These metrics provide a simple financial gauge. We extract SOE data mainly from data provider Wind, which covers 70%-80% of LRG-controlled SOEs, measured by aggregated assets and aggregated liabilities as stated by the Chinese government.

Glossary

- SOE sector leverage: the aggregated debt of SOEs divided by the aggregated EBITDA, for SOEs with available data.
- SOE sector cash coverage for short-term debt: the aggregated cash and short-term securities of SOEs as a % of short-term debts of SOEs, for SOEs with available data.
- SOE sector debt size (indicated by the bubble size in charts): the aggregated debt of SOEs as a % of whole province's LRG revenue. Whole province – inclusive of all governments within a province.

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- China's Fiscal Bid To Stanch Local SOE Debt Risk, Nov. 2, 2023
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- What Are China‘s Options To Resolve Local-Government SOE Debt Risk? Aug. 2, 2023
- China's Local Governments Are Shedding Their Ties To Struggling SOEs, Mar. 1, 2023

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