Urban Development and Sustainable Financial Management in China

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Standard & Poor’s

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Standard & Poor’s Ratings Scale

Applied to:

- Sovereign governments
- Local and regional governments
- Government related entities (GREs)
- Corporations
- Financial Institutions

- AAA ---------- Highest credit quality
- AA
- A
- BBB
- BB
- B
- CCC
- CC
- C
- SD or D ---------------------- Debt in default

China (A+)

• ----------------------- Investment grade cut-off

- ------------------------ Debt in default
What is a Standard & Poor’s Credit Rating

• Unbiased independent evaluation of the creditworthiness of an entity or its securities.
• Globally consistent against standard scale
• Measure of probability of default: likelihood of timely and full payment of principal and interest.

• NOT an equity recommendation
• NOT a recommendation to buy, sell, or hold securities
• NOT an audit
• NOT a measure of liquidity, market value, volatility
• NOT a way of defining “good” or “bad” companies
• NOT a direct assessment of corporate governance
US Corporate Bond Yields (%)  
10 Year Bonds - as at January 14, 2009

Source: Standard & Poor’s Global Fixed Income Research
Analytical Framework: Corporate Issuers

**Business Risk**
- Country risk
- Industry factors
- Competitive position
- Profitability/Peer group comparisons

**Financial Risk**
- Governance/Risk tolerance/Financial policies
- Accounting
- Cash flow adequacy
- Capital structure & asset protection
- Liquidity & short-term factors

Quantitative and Qualitative Perspectives
Role of Ratings: Filling the Gap Between Issuers and Investors

Borrowers/Issuers
- Optimizes cost of funding
- Provides reach and access to broader investors
- Diversification of funding sources

Investors
- Independent opinion of credit quality
- Diversification of investments
- Enhances liquidity in secondary market
- Information and benchmarks to make informed decisions

Benefit of Credit Ratings: Independence, Objectivity, Insightful Analytics

To Issuers:
- Allows fund raising in international capital markets
- Supports disclosure & transparency
- Provides independent peer comparisons to assess risks of financing
- Enhances terms and conditions of borrowings

To Investors:
- Assist in monitoring of overall portfolio risk
- Benchmark for risk premium
- Simple global measure of credit risk
Relevance of S&P Credit Ratings to UDICs in China

- Helping municipal governments to better assess their contingent liabilities and investment portfolios form the bottom-up.
- Helping UDICs to better balance their financial capacity with long-term performance goals.
- Domestic evaluations of credit strength heavily influenced by UDIC relationship with government. Results likely to be more reflective of government support than company’s financial characteristics.
- S&P credit rating process allow an independent assessment of the specific strengths and weaknesses of the companies concerned in terms of being supportive of creditworthiness.
- S&P credit rating process provides an independent comparison in terms of credit factors with relevant commercial peers in China (where available) and outside of China.
State Government (rated by S&P)

State GRE better able to borrow:
- Full evaluation of financial management capabilities, planning, and capacity.
- Evaluated based on stand alone credit profile and debt capacity (strength = lower cost of capital).
- Improved incentives for financial discipline.
- Incentives for integrating best practices into planning and management.

State GRE borrows at interest rate plus guarantee fee based on S&P analysis

State GRE (evaluated and rated by S&P – standalone)

Ex. AA

AA + Guarantee Fee
What is an FMA?

FMA = Financial Management Assessment: is a comprehensive assessment of the financial management sophistication and quality of a public sector entity. Public sector entities include local and regional governments (LRGs) and government related entities/companies (GREs).

FMA service is designed to:

- Help understand specific strengths and weaknesses in key areas of an LRG/GRE financial management;
- Benchmark against peers and global good practices in public finance;
- Help understand adequacy of the entity’s policies in the local context;
- Improve transparency of LRG/GRE finances, operations and management practices;
- Track progress in financial management;
- Help maximize fiscal and financial resources.
Why FMA?

- Focus by Multilateral Institutions and Central Governments on building financial management capacity and accountability at subnational level
- Growing demand for public sector transparency and accountability in emerging markets
- Continuing public finance reforms across emerging markets
- Growing need for global benchmarking of public finance quality
- Need to enhance information provided by a credit rating/credit report
- Assist LRGs/GREs better access and best manage proceeds from capital markets
- Instill awareness of financial management and financial discipline

AND

- Desire to leverage on S&P’s global experience and expertise in assessing quality of public finance management
- S&P participation in the WB project in Russia 2001-2004: Code of Best Practices and over 50 other deliverables
- S&P participation in WB Chongqing project: first FMA and standalone credit assessment.
Local GRE’s Re-Entering Debt Markets

China - Local GRE Domestic Bond Issuance

Total Issuance (2005-present): RMB 162.3 billion
Coupon Range: 4.0-8.35% (A – AAA)
Current SOE/UDIC Borrowing Practices

• Heavy reliance on bank funding, often relying on a single bank for a large share of borrowing
• Where bond financing is used, credit ratings assigned reflect mainly the guarantees rather than the credit quality of the issuer
• Rudimentary and fragmented credit assessment systems in branches of the major commercial banks leads to:
  • Dependence on guarantee and collaterals for lending decisions
  • Willing to increase lending to SOEs even when financials indicators are weak, partly on account of expected government support
• Preferred status of SOEs often reduce availability of financing to private businesses, especially during the monetary policy tightening of 2007 to early 2008
• Current RMB4 trillion program and the decentralized nature of local government projects – are local governments and their entities ready to embark on borrowing?
# Funding Sources for Capital Projects

<table>
<thead>
<tr>
<th>Source</th>
<th>“Pros”</th>
<th>“Cons”</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Non-Debt Sources</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Own Resources</td>
<td>Cheap</td>
<td>Rarely sufficient, esp. for large-scale projects</td>
</tr>
<tr>
<td>Grants Central Gov / Funding</td>
<td>Cheap, technical support from funding orgs</td>
<td>Restriction on the use of funds, slow pace of</td>
</tr>
<tr>
<td>Organizations</td>
<td></td>
<td>approval, strict control, political issues</td>
</tr>
<tr>
<td>PFI/PPP Deals</td>
<td>No direct costs, more effective private sector</td>
<td>Long-term agreement with concessionaires, off-</td>
</tr>
<tr>
<td></td>
<td>provision of services</td>
<td>balance sheet risks</td>
</tr>
<tr>
<td><strong>Debt Sources</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loans from Multilateral Orgs.</td>
<td>Long-term, amortizing, favorable interest rates,</td>
<td>Often restrictions on the use of funds and FX</td>
</tr>
<tr>
<td></td>
<td>know-how</td>
<td>risk; slow pace of approval</td>
</tr>
<tr>
<td>Domestic/Foreign Bank Loans</td>
<td>Local currency</td>
<td>Often restricted capacity and illiquid (+FX risk</td>
</tr>
<tr>
<td></td>
<td></td>
<td>for foreign)</td>
</tr>
<tr>
<td>Bonds</td>
<td>Diversity of investors, liquidity, depth of</td>
<td>Expensive depending on size, bullet repayments</td>
</tr>
<tr>
<td></td>
<td>markets</td>
<td>(+FX risk for foreign)</td>
</tr>
<tr>
<td>Off-budget / Via Enterprises</td>
<td>No direct costs</td>
<td>Contingent liabilities, lack of transparency and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>more expensive</td>
</tr>
</tbody>
</table>
Debt policy

- **Long-Term Strategy**: Financial policy of the LRG should include guidelines on debt burden limits and debt structure.
- **Public Sector Debt and Interests**: Commercial risks could weaken government services. Debt should not be used to fund operating expenditure and speculative financial investments.
- **Asset-Liability Matching**: Short-term debt should be incurred for liquidity purposes only.
- **Multi-Year Budgeting**: Consider future operating costs into financial projections.
- **Contingent Liabilities and Transparency**: The government should analyze and publish data on its contingent liabilities, including debt obligations and finances of government enterprises.
- **Narrow Role for Guarantees**: Should be limited to the arrangement of funding for infrastructure and in order to reduce borrowing costs. Guarantees should not be used as a “deferred payment” tool, when it is known upfront that the borrower will not fulfill its obligation.

Debt structure

- Long-term debt should represent the majority of the debt portfolio.
- The debt structure should allow for even repayment of principal across years.
- Currency and interest risks should be hedged, where possible.
- The debt portfolio should be diversified by the type of obligation and creditor.
- Prioritized servicing of debt (discrimination of creditors) is possible only if required by borrowing terms and conditions.
- Detailed debt service and repayment forecasts should be prepared for the whole life of the longest obligation.

*Good policy reduces borrowing costs*
Risks of Current Practices

- SOEs become highly leveraged relative to commercial peers. Liquidity risks are high due to heavy interest payments.
- Negative economic shocks could trigger a liquidity crisis at one or more SOEs and escalate risks of default.
- Similarly, an adverse change of opinion regarding the credit quality of the SOE could also cause liquidity problems.
- Extensive cross-guarantees among SOEs creates the risk of a chain of defaults.
Risks of Current Practices (cont’d)

• Government supervision rely on administrative rules (e.g. NDRC approval of projects) and focus mainly on protection of state assets and short term profitability.

• Lack of market indicators and still developing risk management capabilities at local government agencies leads to weak oversight of SOE financial stability.

• Current fiscal stimulus, driven by central government, could spur already debt-burdened SOEs to increase leverage still further. Financial fragility could deteriorate without market-based guidelines.

• Importance of SOEs, especially UDICs, mean that local governments will very likely extend financial support to distressed entities. This would weaken the financial position of the government.

• Should a number of key SOEs fall into financial distress simultaneously, the financial burden may rise beyond governments’ ability to support. Further investments will fall steeply and services may be disrupted.
Mission-orientation is high

• UDICs strongly focused on their mission and quantitative targets in the respective five-year plans.
• Project plans typically subject to close review by the companies involved and relevant authorities.
• Detailed implementation plans are often made and progress monitored regularly.

Financial policies often do not match up

• Often inadequately capitalized due to the lack of funding on the part of the local government concerned.
• Prudential guidelines regarding debt and liquidity often not formalised
• Heavy reliance on bank debt and debt levels often high by standards of commercial firms due to the need to fulfill government mandated investment
• Cash flows from operations often negative due to low profitability of their business operations or investments.
Distracting diversification

• Struggle to balance the need to fund mandated investments, SASAC financial targets for top managers and cash-flow to stay afloat often prompt them to enter into ancillary or even unrelated activities to generate funds e.g. real estate development.

• Local governments support by favorable regulations and selling prime land at below market price

Banks supportive despite high debt levels

• Partly because of available collaterals such as completed facilities and land

• Government support also considered favorably, especially when arrangements are made for stronger SOEs to guarantee loans to weaker ones

• This creates a triangular creditor-debtor-guarantor relationship that may deepen credit risks when something goes wrong.
Weak Financial Measures – an illustration

<table>
<thead>
<tr>
<th></th>
<th>HK Peer #1</th>
<th>HK Peer #2</th>
<th>SOE Peer #1</th>
<th>SOE Peer #2</th>
<th>UDIC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oper. income (bef. D&amp;A)/revenues (%)</td>
<td>52.0</td>
<td>72.2</td>
<td>38.7</td>
<td>30.7</td>
<td>47.3</td>
</tr>
<tr>
<td>Total debt/debt plus equity (%)</td>
<td>55.3</td>
<td>27.9</td>
<td>68.8</td>
<td>53.9</td>
<td>76.3</td>
</tr>
<tr>
<td>Debt / EBITDA (x)</td>
<td>2.5</td>
<td>1.3</td>
<td>6.0</td>
<td>4.0</td>
<td>12.2</td>
</tr>
<tr>
<td>EBITDA interest coverage (x)</td>
<td>3.5</td>
<td>21.6</td>
<td>3.8</td>
<td>6.0</td>
<td>24</td>
</tr>
<tr>
<td>Funds from operations/debt (%)</td>
<td>29.3</td>
<td>64.1</td>
<td>11.5</td>
<td>22.0</td>
<td>9.4</td>
</tr>
<tr>
<td>Return on capital (%)</td>
<td>17.9</td>
<td>15.3</td>
<td>8.3</td>
<td>9.2</td>
<td>3.8</td>
</tr>
</tbody>
</table>

Credit strength is below peers.

Relatively strong operating performance
But leverage is higher than peers
Interest payments consumes much of profits
Cash flow is weak due to heavy investment and interest payments
Bottomline is weak despite good operating performance
## Some UDICs Are Financially Weaker

<table>
<thead>
<tr>
<th></th>
<th>UDIC #1</th>
<th>UDIC #2</th>
<th>UDIC #3</th>
<th>UDIC #4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oper. income (bef. D&amp;A)/revenues (%)</td>
<td>11.7</td>
<td>5.9</td>
<td>71.4</td>
<td>47.3</td>
</tr>
<tr>
<td>Total debt/debt plus equity (%)</td>
<td>72.0</td>
<td>51.0</td>
<td>75.0</td>
<td>76.3</td>
</tr>
<tr>
<td>Debt / EBITDA (x)</td>
<td>169.0</td>
<td>3.4</td>
<td>31.8</td>
<td>12.2</td>
</tr>
<tr>
<td>EBITDA interest coverage (x)</td>
<td>0.1</td>
<td>4.6</td>
<td>0.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Funds from operations/debt (%)</td>
<td>-4.6</td>
<td>21.7</td>
<td>-0.6</td>
<td>9.4</td>
</tr>
<tr>
<td>Return on capital (%)</td>
<td>1.4</td>
<td>17.7</td>
<td>0.0</td>
<td>3.8</td>
</tr>
</tbody>
</table>
## Financial Management Assessment – An Example

<table>
<thead>
<tr>
<th></th>
<th>Sophistication and Adequacy of Systems &amp; Policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic management, organization structure, and corporate culture</td>
<td>Intermediate (2)</td>
</tr>
<tr>
<td>Financial policies and planning</td>
<td>Basic (1)</td>
</tr>
<tr>
<td>Operational management</td>
<td>Sound (3)</td>
</tr>
<tr>
<td>Transparency and reporting</td>
<td>Basic (1)</td>
</tr>
<tr>
<td>Ownership structure and government influences</td>
<td>Basic (1)</td>
</tr>
<tr>
<td>Key governance structure, independence, and effectiveness</td>
<td>Intermediate (2)</td>
</tr>
</tbody>
</table>

### FMA Scale:

- **5** Advanced level of practices
- **4+** Sophisticated (mostly sound and advanced)
- **3+** Sound level of practices
- **2+** Intermediate (mostly basic and sound)
- **1+** Basic level of practices in most areas
- **0** Lack of many basic practices
Strengths

• Clear corporate objective that is well communicated at different levels of the organization

• Stringent system of monitoring on the progress of its construction activities. Implementation

Weaknesses

• Lack of medium term financial planning, with much of such planning focused on near term needs.

• Weak liquidity management practices that expose company to a higher level of liquidity risk than international peers.

• Unsophisticated debt management system resulted in a concentration of liability base.
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Appendix

FMA for Government Related Entities: Assessing Capacity and Constraints
FMA Scale – Leveraging Models and Experience

Each of the 9 elements is assessed in terms of Progressiveness of Systems and Policies and their Performance:

Applied to:
- Local and regional governments (LRG)
- Government related entities (GRE)

1+ Basic level of practices in most areas
2 Intermediate (mostly basic and sound)
3+ Sound level of practices
4+ Sophisticated (mostly sound and advanced)
5 Advanced level of practices
0 Lack of many basic practices
Six analytical elements of FMA for GREs

1. Strategic management, organizational structure and corporate culture
2. Financial policies and planning
3. Operational management
4. Transparency and reporting
5. Ownership and board structure, and government relations
6. Key governance structures, independence and effectiveness

Analytical questions:
- What business processes, systems and policies are in place?
- How do they stand against principles of good practice and peer company practices? Are they adequate to the current environment and company’s needs?
- What is the performance level of these sets of business processes?

Analytical outcome:
- Opinion on strengths, weaknesses and risks of the company’s financial management systems and practices in the context of global good practices and local environment.
<table>
<thead>
<tr>
<th>1. Strategic management, organizational structure and corporate culture</th>
<th>4. Transparency and reporting</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a. Strategy</td>
<td>4a. Public reporting</td>
</tr>
<tr>
<td>1b. Organizational structure</td>
<td>4b. Accounting policy/standards</td>
</tr>
<tr>
<td>1c. Corporate culture</td>
<td>4c. Financial statements</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Financial policies and planning</th>
<th>5. Ownership structure and government influences</th>
</tr>
</thead>
<tbody>
<tr>
<td>2a. Business (financial) plan</td>
<td>5a. Ownership, regulatory and consumer roles</td>
</tr>
<tr>
<td>2b. Debt management</td>
<td>5b. Owner’s control and oversight from the government</td>
</tr>
<tr>
<td>2c. Dividend policy</td>
<td>5c. Influence from other stakeholders</td>
</tr>
<tr>
<td>2d. Liquidity and cash management</td>
<td></td>
</tr>
<tr>
<td>2e. Risk management (insurance)</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Operational management</th>
<th>6. Key governance structures, independence and effectiveness</th>
</tr>
</thead>
<tbody>
<tr>
<td>3a. Operating performance</td>
<td>6a. Board of Directors / Management board / Committees / CEO</td>
</tr>
<tr>
<td>3b. Sales and billing systems; supply management; working capital management; fixed assets management</td>
<td>6b. Internal control</td>
</tr>
<tr>
<td>3c. management experience and proficiency</td>
<td>6c. Conflict of interest, related-party transaction</td>
</tr>
</tbody>
</table>
### Examples: Progressiveness vs. Performance

<table>
<thead>
<tr>
<th></th>
<th>Progressiveness of Systems and Policies</th>
<th>Performance Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgeting</strong></td>
<td>Existence of internal and/or external audit of government financial statements, government entities…</td>
<td>Qualifications, sudden changes of auditors, severe delays in completion…</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Deviations from original budgets, timeliness, sudden revisions, …</td>
</tr>
<tr>
<td><strong>Liquidity management</strong></td>
<td>Existence and sophistication of treasury systems, cash flow planning, …</td>
<td>Deviations from original budgets, timeliness, sudden revisions, …</td>
</tr>
<tr>
<td><strong>Auditing</strong></td>
<td>Accounting basis, methods, coverage of budgeting, …</td>
<td>Overdue payables, cash shortages, average transaction turnover, …</td>
</tr>
</tbody>
</table>
Example: Annual budgeting

**Progressiveness:**

- Budgeting basis: cash, accrual or mixed?
- Budgeting methods: indexation, norms, zero-based budgeting, program-based budgeting etc?
- Financial resources and entities controlled by the government in/outside of the budget.
- Transparency of the appropriations structure.
- Internal and external budget consultations.
- Information systems.

**Performance:**

- Timely approval of annual budgets?
- Deviations of actual numbers from initially budgeted figures?
- Significance, reasons and frequency of budget revisions.
- Conflicts on budget issues between legislative and executive branches?
The FMA Process

1. Information collection stage

2. Management meetings
   1-2 day meetings with company and government officials (finance, planning, control, line departments etc.)

3. Information analysis and an internal evaluation report

4. FMA assessment committee

5. Final FMA evaluation report

Opportunities for Continuing Cooperation
Scores for 9 or 6 elements of financial management
Overview of key strengths and weaknesses
Peer comparison
Trends and challenges going forward
Summary table: strengths and weaknesses for each element
Comparison relative to best practices
Financial and economic statistics