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CHINA

China's Riskiest Form of State Borrowing Enjoys a New Boom

Investor enthusiasm is rising for debt issued by the investment arms of cities and provinces

China is using infrastructure investment to help the economy. **PHOTO:** QILAI SHEN/BLOOMBERG NEWS

By Shen Hong

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SHANGHAI—The investment arms of China's cities and provinces are selling debt at a record pace to fund roads, railways, utilities and ports, as they seek to shore up growth by spending more on infrastructure.

Smaller cities and counties in China have long used local government financing vehicles to raise money via debt that is kept off the books of the municipalities themselves. The borrowers are often heavily indebted and lack formal state backing, although they are typically seen as carrying an implicit guarantee that Beijing would bail out investors if debts can't be repaid.

Even so, some investors have viewed them as one of China's riskiest categories of bonds. In 2014 for instance, Beijing—concerned about debt buildup and a lack of transparency—imposed a short-lived ban on debt issuance of this sort by the investment arms of cities and provinces.

> However, as the central government has relaxed its stance on debt buildups, investors are warming to the funding vehicles, effectively betting state support will be there if needed.

Local government financing vehicles have issued 2.37 trillion yuan ($332 billion) of domestic bonds this year. That total is up 38% from the same period in 2018, and is poised to break the full-year record of 2.56 trillion yuan set three years ago. Overseas issuance in dollars has hit $23 billion: up 56% year-over-year, and nearing 2018's full-year record of $24 billion.

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Laura Li, a Hong Kong-based analyst at S&P Global Ratings, said this was a good time for the borrowers to refinance or otherwise raise funds because China's official stance was supportive, given infrastructure investment remains vital to keeping the economy humming.

The blizzard of sales is partly about refinancing: A record 2.1 trillion yuan of debt from local government financing vehicles has either matured this year, or will do by year-end, according to Wind, a data provider. Next year another 1.7 trillion yuan comes due. Offshore debt maturities are rising too, and will hit $25.3 billion in 2021.

This type of debt issuance took off when local authorities were barred from borrowing directly from banks or bond markets. From 2015, Beijing has allowed regional governments to sell "special purpose bonds" directly, to fund public works, with the aim of gradually replacing this off-balance-sheet debt.

But, said Ms. Li: "The current scale of special-purpose bonds issued by local governments is not enough to cover the funding needs of all these projects." That's partly because only provincial-level governments and a few municipalities are allowed to issue local government bonds, while a lot of infrastructure projects are carried out at much lower levels.

Investor enthusiasm has risen. Amid a broader bond market rally, average yields on five-year debt with a AA domestic credit rating issued by local government financing vehicles across China have fallen to 4.21% from 4.68% at the end of last year. Bond prices rise when yields decline. The issuers include borrowers from affluent areas like eastern Zhejiang province, as well as those from less developed regions, such as Inner Mongolia in the north.

On a relative basis, borrowing costs have fallen too: Yields are now about 1.2 percentage points above those on corresponding Chinese government bonds, the narrowest gap in nearly three years. This gap, known as the credit spread, measures the extra return investors demand for investing in riskier corporate bonds rather than safer government debt.

The comparative appeal of these bonds has also risen as defaults on bonds issued by private

Local governments in China often aren't able to directly raise enough money to cover the funding needs of infrastructure projects. **PHOTO:** LIN ZEJUN/SIPA ASIA/ZUMA PRESS

companies have climbed sharply. These debtors have limited access to loans from China's banks, which are mostly state-backed, and are less likely to secure tax breaks.

Corporate bonds with a face value of 122.3 billion yuan have defaulted so far in 2019, up 35% year-over-year. Of the 150 bonds that have gone sour this year, all but nine were issued by private firms.

"The continued rise in defaults on corporate bonds issued by other types of companies also has boosted investors' sense of security" about bonds from local government financing vehicles, said Meng Huan, a bond-fund manager at Shanghai Yunhan Asset Management Co.

Many funding vehicles rely on government subsidies to stay afloat and none have ever defaulted. However, analysts say default isn't a purely financial question. Some other government-related issuers have failed to repay investors recently, such as aluminum maker Qinghai Provincial Investment Group Co.

"Beijing's policy priority of maintaining financial stability also offers some sense of security to investors," said S&P's Ms. Li, adding that the local government funding vehicles play a very important role in the capital market and financial system.

They are also seen as crucial to the reputation of local officials, who would probably do everything possible to keep them in business. "Nobody wants to be the first to default and no local officials want to lose their jobs because of that," said a Beijing-based head of bond underwriting at a large Chinese brokerage.

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