

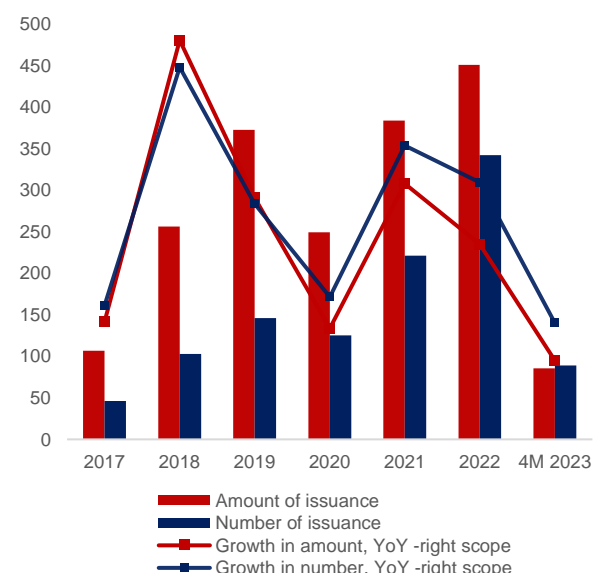
## Non-rating Action Commentary: More Low-tier LGFVs Are Issuing Offshore Bonds, with RMB Issuance Predominating

The offshore bond issuance by local government financing vehicles (LGFVs) has decreased year-on-year in 2023, while the average issue yield continues to rise.

In the past few years, offshore LGFV bond issuance has shown a generally upward trajectory. In 2021 and 2022, offshore bond issuance by LGFVs experienced high growth rates of 54% and 17.5% respectively, fuelled by favourable offshore issuance conditions and policies (Exhibit 1). However, in 2023, the scale of offshore issuance has significantly contracted due to a combination of continued interest rate hikes by the Federal Reserve and tighter offshore financing policies. The newly issued LGFV offshore bonds in the first four months of 2023 amounted to approximately USD8.6 billion, with 89 issues, representing a 52.5% decline in issue amount and a 30% decline in the number of issues compared to the previous year. Despite the decline in offshore issuance, the large overall due amount of LGFV bonds in 2023 means that the refinancing pressure on LGFVs remains significant. Additionally, LGFVs face rigorous restrictions on domestic financing. Therefore, we anticipate that LGFVs will continue to have considerable demand for offshore borrowing this year, and that offshore bond issuance will persist at a certain level.

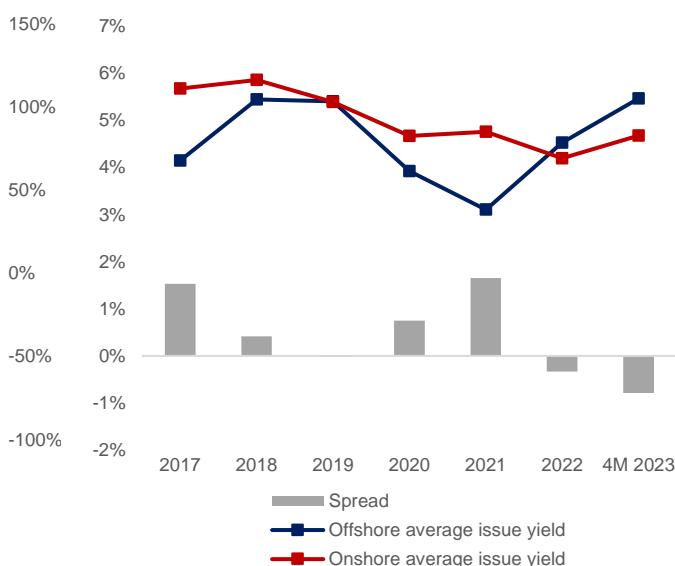
The lower cost of offshore financing has been a primary factor attracting LGFVs to issue offshore bonds over the years. However, since 2022, there has been an inversion in the cost of issuing onshore and offshore bonds for LGFVs. In the first four months of 2023, the average issue yield of offshore LGFV bonds has further increased, with the average issue yield of 1-5 year bonds reaching 5.5% (Exhibit 2). The spread between the average issue yield of offshore LGFV bonds and that of domestic LGFV bonds in the same period has expanded to 0.8 percentage points. We believe the increase in the average issue yield of offshore LGFV bonds can be attributed to the persistent rise in US interest rates, a substantial increase of RMB-denominated issuance, and the growth in the number of low-tier (low administrative level) LGFV issuers. The overall decline in credit quality among LGFV issuers has pushed up the issue yield of LGFV offshore bonds. Nonetheless, we anticipate that offshore financing costs may ease over the long term as the Federal Reserve's interest rate hike cycle comes to an end, which could result in a return to normalcy in US monetary policy.

Exhibit 1: LGFV offshore bond issuance amount (USD10 mil.)



Sources: DMI, Wind, CSPI ratings

Exhibit 2: The average issue yield of LGFV bonds (1-5 years)



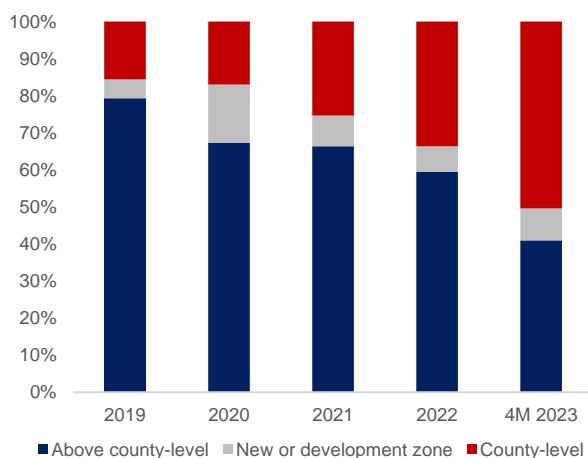
Sources: DMI, Wind, CSPI ratings

## Lower-tier LGFVs become major offshore issuers, with RMB-denominated bonds growing in popularity

In light of tightened regulations on the domestic financing of LGFVs, county-level LGFVs have found it increasingly challenging to issue bonds onshore. To address their financing needs, many of these LGFVs are turning to offshore bond markets as an alternative source of funding. By accessing offshore bond markets, LGFVs can potentially reduce their financing costs and diversify their financing channels, expanding their access to different financing tools. The proportion of offshore bond issuances by county-level LGFVs has been steadily increasing, reaching 34% in 2022 and surpassing 50% in the first four months of 2023, indicating a significant shift in the composition of LGFV offshore bond issuers towards lower administrative levels (Exhibit 3). However, this trend also highlights the growing credit profile differences among LGFV issuers at different administrative levels, posing a challenge for international investors in managing the associated credit risks. As a result, there is a pressing need for an objective and differentiated international credit rating system to help investors better assess the creditworthiness of LGFV issuers at different administrative levels.

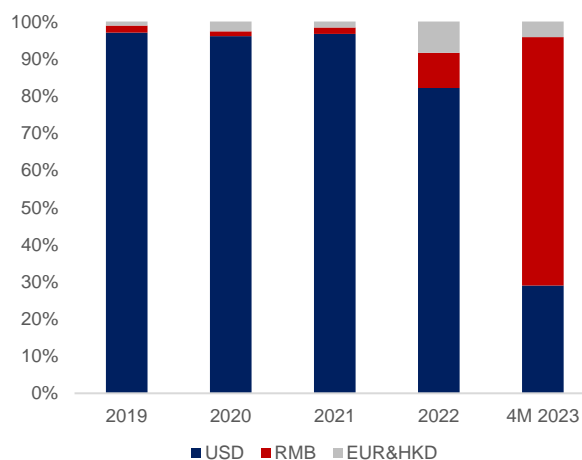
In terms of the currency choice of bond issuance, offshore bonds issued by LGFVs have primarily been denominated in USD in previous years. However, since 2022, the rising costs associated with issuing USD-denominated bonds have prompted more LGFVs to turn to RMB-denominated bonds. In the first four months of 2023, the issuance of offshore LGFV bonds denominated in RMB surged, accounting for 67% of the total offshore LGFV bond issuances. (Exhibit 4). Offshore RMB bonds in the Shanghai Free Trade Zone (FTZ) have become increasingly popular recently due to their lower cost of borrowing, absence of foreign exchange risk, easy fund transfer, and policy benefits. However, there are also some drawbacks, such as limited offshore RMB funding, incomplete supporting facilities for the FTZ offshore bond market, a concentrated investor structure, and relatively weak liquidity. We believe that while short-term currency preference shifts for bond issuances are driven by market factors, the development of RMB offshore bonds will become more stable in the long run as the promotion of RMB internationalization progresses, and the USD will remain a prevalent currency for Chinese companies' offshore financing as US monetary policy normalizes.

Exhibit 3: Proportion of county-level LGFV issuance increases



Sources: DMI, CSPI ratings

Exhibit 4: Proportion of RMB-dominated issuance surges



Sources: DMI, CSPI ratings

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