FINANCIAL ANALYSIS

A. Introduction and Methodology

1. The financial analysis is in accordance with Asian Development Bank (ADB) guidelines.[1] All components in the project design are not revenue generating. Thus, the financial analysis focuses on the ability of the Huanggang municipal government (HMG), the end borrower, to service project debts and to provide required counterpart funds. ADB loan funds are channeled to the project through the Hubei Provincial Finance Department (HPFD) to HMG as the end borrower. Accordingly, HMG is responsible for servicing and repaying the ADB loan, while Huanggang Urban Construction Investment Company (HUCIC) is nominally responsible for servicing and repaying the domestic bank loans as part of the counterpart funding. As the project is not revenue generating, HUCIC gets no financial benefit from the project or from discharging its responsibilities as project implementing agency. In addition to assuming responsibility for the ADB loan, HMG has provided assurances on the availability of counterpart funds and for all project recurrent expenses. Also, HMG is the principal owner of HUCIC, which is wholly state-owned and is the primary guarantor for project implementation. Thus, the fiscal sustainability analysis of HMG was to ensure its financial capacity is adequate to meet its potential financial duties.

2. During project implementation, contractors will submit their payment claims to HUCIC for approval. Following approval, HUCIC will settle claims financed from counterpart funds. It will then prepare a withdrawal application for the ADB loan element (if any) and send it to the Huanggang project management office (HPMO) for review and endorsement. Following HPMO's endorsement, the withdrawal application is submitted to the Huanggang Municipal Finance Bureau (HMFB). HUCIC will be informed for accounting purposes. Financial management assessments were therefore conducted on HMFB and HUCIC.

B. Financial Sustainability Analysis

3. **Financial obligations arising from the project**. The project costs from the HMG's own resources amounts to $71.3 million (CNY438.2 million) during the 2014–2019 construction period (approximately CNY73.0 million per annum). Anticipated debt service obligations and operating expenses for 2020–2029 are provided in Table 1.

Table 1: Estimated Average Debt Servicing and Operating Expenses, 2020–2029
(CNY million)[a]

Item	2020–2024	2025–2029
Asian Development Bank debt service[b]	42.1	38.9
Domestic bank debt service[c]	118.9	0.0
Operating expenses[d]	4.9	6.0
Total	**165.9**	**44.9**

[a] Exchange rate used $1 = CNY6.15.
[b] Interest during construction on the ADB loan computed at 2.081%, is the sum of the 5-year dollar fixed swap rate plus a spread of 0.50% and a maturity premium of 0.10%. Commitment charges are computed as 0.15% per year of the average undisbursed amount. Repayment is on a straight-line basis over 20 years. Financing charges during implementation are not capitalized but are applied to the account of the Huanggang municipal government.
[c] The domestic loan carries an interest rate of 6.55% and will be repaid over 5 years after a 5-year grace period. The principal is CNY500 million ($81.3 million). Repayment is on an annuity basis, in which case, annual payments (of interest and principal) are CNY118.9 million ($19.3 million) assuming payments at 6 monthly intervals.
[d] Includes labor costs, energy, fuel, repair costs, and overhead.
Source: Asian Development Bank estimates.

[1] ADB. 2005. *Financial Management and Analysis of Projects*. Manila; and ADB. 2009. *Financial Due Diligence: A Methodology Note*. Manila.

4. **Ability of HMG to meet financial obligations**. Huanggang Municipality is one of the 12 prefecture-level cities in Hubei Province. HMG is located in Huangzhou District (the only urban district in Huanggang Municipality). Like all such governments in the People's Republic of China (PRC), HMG has its own fiscal revenues to support its administrative (government) functions. Based on financial information provided by HMFB, the overall fiscal income of HMG includes tax income, nontax income, transfer payments from central and provincial governments through tax-sharing arrangements, general transfers, and allocated funds. Table 2 shows HMG's fiscal and nonfiscal income during 2008–2012, when total income rose at a compound annual rate of 37% (in nominal terms). If allocated funds and the proceeds of state bonds are excluded, neither of which are available for project purposes, the annual rate of increase falls to 31%.

Table 2: Huanggang Municipal Government Income, 2008–2012
(CNY million)

Item	2008	2009	2010	2011	2012
Tax income	203.4	237.2	292.6	535.4	669.1
Nontax income	127.3	159.3	186.4	236.6	287.7
Transfer payments					
Tax-sharing arrangements	79.8	110.2	102.6	104.7	107.3
General transfers	221.6	456.1	431.2	540.0	638.7
Allocated funds	276.7	474.3	1,018.9	865.9	756.1
State bonds			145.3	299.6	586.6
Income from other sources	31.0	44.8	62.3	12.7	238.3
Total income	**939.8**	**1,481.9**	**2,239.3**	**2,594.9**	**3,283.8**

Note: Financial statements for 2013 will be available after June 2014.
Source: Huanggang Municipality. 2013. *Huanggang Finance Yearbook, 2012.* Huanggang.

5. Income in 2012 was CNY1,941 million, net of allocated funds and state bonds. Table 3 assumes that this net amount grows initially by about 30% a year, slowing to 20% in 2019, and compares these net amounts with the average annual HMG resources required during implementation, and with the sum of HMG resources and potential liabilities for state bonds and World Bank loans.

Table 3: Projection of Net Income of Huanggang Municipal Government, 2014–2019
(CNY million)

Item	2014	2015	2016	2017	2018	2019
A. Total budget income[a]	3,280	4,100	5,125	6,304	7,628	9,154
B. Average contribution to project[b]	73	73	73	73	73	73
C. Average contribution to project as percentage of total budget income (B / A)	2.2%	1.8%	1.5%	1.2%	1.0%	0.8%
D. Liabilities for state bonds, World Bank loans	56	130	130	130	130	130
E. Sum of liabilities of state bonds and World Bank loans and average contribution to project as percentage of total budget income (B + D) / A	3.9%	4.9%	4.0%	3.2%	2.7%	2.2%

[a] Estimated income after allocated funds and state bonds.
[b] Average annual contribution to project from Huanggang municipal government resources (2014–2019).
Source: Asian Development Bank estimates.

6. The comparison shows that the most difficult year is 2014, but the contribution is still less than 3% of HMG's annual income, suggesting that HMG would have no difficulty meeting these obligations, if needed. HMG would also have to make payments on state bonds and service three World Bank loans, amounting to CNY130 million a year from 2015 to 2019. In the worst case in 2015, the total commitment is 4.9% of budget revenues. Once debt service starts in 2020, HMG's potential annual liability will rise to include ADB project debt service plus any remaining obligations related to state bonds and World Bank loans. Assuming the bonds are

repaid over 3–10 years and World Bank debt service is CNY0.7 million per year (at the end of 2012, World Bank debt was less than CNY10 million and the repayment period less than 15 years), their combined charge would amount to CNY112 million.

7. Based on this scenario, repayment will be affordable. If HMG's income in 2020 is 10% higher than that projected for 2019, the liability only amounts to 2.8% of income (Table 4). This is calculated as follows: budget income of CNY10,069 million, covering project debt service and operations of CNY167 million plus state bond payments of CNY111 million and World Bank repayments of CNY0.7 million. The position thereafter continues to improve (Table 4).

Table 4: Projection of Net Income of Huanggang Municipal Government, 2020–2024
(CNY million)

Item	2020	2021	2022	2023	2024
A. Total budget income[a]	10,069	11,076	12,184	13,402	14,742
B. ADB project debt service plus opex	166.8	166.3	165.9	165.4	165.0
C. ADB project debt service plus opex as percentage of total budget income (B / A)	1.7%	1.5%	1.4%	1.2%	1.1%
D. Liabilities for state bonds, World Bank loans	112	74	74	0	0
E. Sum of liabilities for state bonds, World Bank loans, and ADB project debt service plus opex as percentage of total budget income (B + D) / A	2.8%	2.2%	2.0%	1.2%	1.1%

ADB = Asian Development Bank, opex = operational expenditure.
[a] Estimated income after allocated funds and state bonds, increasing from 2019 at 10% annually.
Source: Asian Development Bank estimates.

8. The percentages in Table 4 are based on a worst-case scenario. They assume that all of the HMG's contingent liabilities to lenders materialize and that HMG is responsible for the entire "own resources" share of financing.

9. **HUCIC's financial position**. HUCIC, formed in June 2006, is a state-owned enterprise with registered capital of CNY310 million. The HMG contributed capital (CNY84 million) in cash and Huangzhou district government contributed CNY10 million. Capital also appears to have been provided in the form of land: 42.6 hectares by the municipality and 31.4 hectares by the district. The audited financial statements of HUCIC for 2009–2012 are summarized in Table 5.

Table 5: Huanggang Urban Construction Investment Company: Summary Financial Statements, 2009–2012
(CNY million)

Item	2009	2010	2011	2012
Total assets	4,932.2	5,492.8	6,329.5	18,023.4
Including current assets	680.7	821.4	1,246.6	11,848.9
Total liabilities	1,119.2	1,178.0	1,332.0	3,549.3
Including current liabilities	174.6	175.0	266.6	327.6
Total equity	3,813.0	4,314.8	4,997.5	14,474.1
Business revenues	87.5	623.4	538.4	432.8
Operating expenses	23.2	118.1	80.2	255.4
Operating profits	64.3	505.3	458.2	177.4
Nonoperating revenues	26.1	1.8	0.2	60.3
Nonoperating expenses	0.1	0.1	0.1	0.1
Total profits	90.3	507.0	458.3	237.6
Income tax	9.8	5.2	5.6	(1.9)
Net profits	80.5	501.8	452.7	239.5

Source: Huanggang Urban Construction Investment Company.

10. HUCIC, acting on behalf of its owners, is a land procurement and development agent. It raises funds in its own right (i.e., without a formal government guarantee) and retains the net proceeds of any commercial transactions it undertakes. It plays no part in managing or operating any of the fixed assets it has helped to create. HUCIC holds a large inventory of undeveloped land, with a balance sheet value of approximately CNY9,272 million at the end of 2012. Works in progress (road construction and rehabilitation, lake rehabilitation, storm water and wastewater treatment, industrial park construction, sanitation, and landscape improvement) are substantial, with a balance sheet value of approximately CNY2,285 million.

11. Although Table 5 suggests that HUCIC has been profitable, its return on net fixed assets has varied, from 1.5% in 2008 to 11% in 2010. Its business is risky. It faces high up-front costs for land development, and the timing and scale of sales revenues are uncertain. It does not appear to have a formal business plan, therefore future financial performance is very difficult to predict. Thus, insulating the ADB project from any financial instability arising from HUCIC's land transaction business would be prudent. The proposed flow of ADB funds is designed to achieve this. The detailed arrangements can be found in the project administration manual.

C. Financial Management Assessments

12. Financial management assessments were carried out in accordance with ADB's Financial Management and Analysis of Projects to assess the financial management capacity of HMFB and HUCIC (footnote 1). The assessment includes fund-flow arrangements, staffing, accounting policies and procedures, internal and external auditing arrangements, reporting and monitoring, and financial information systems.

13. HMFB's international department has 2 staff, while the treasury team has more than 15. All have financial or accounting education backgrounds and are very familiar with rules and procedures regarding domestic projects. However, the proposed project is the first ADB project for which they have full responsibility for preparation and implementation, although they have prior experience with World Bank projects. HMFB staff will need training in ADB disbursement, accounting and reporting procedures, and financial management. They will also need training in local financial procedures and reporting requirements related to foreign-funded projects.

14. HUCIC has only three financial staff—a financial manager, an accountant, and a cashier—meeting the minimum requirements for financial personnel. Given the scale of its activities, HUCIC needs to increase the number of financial staff. If approved, this will be HUCIC's first multilateral funded project. Its financial staff therefore needs training in ADB and associated local financial procedures and reporting requirements.

15. The assessment concludes that HMFB and HUCIC are inexperienced in managing ADB projects, hence the project capacity development component will provide significant assistance on ADB policies and procedures, including procurement and disbursement, project accounting, auditing, and the management of financial risk. Based on the financial management assessments, the risk assessment for HMFB and HUCIC is shown in the Risk Assessment and Risk Management Plan. Details of financial management capacity building to mitigate the financial risks are provided in the project administration manual.