MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
17 December 2021

Rate this Research

RATINGS

Zagreb, City of

Domicile	Zagreb, Croatia
Long Term Rating	Ba1
Type	LT Issuer Rating
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Harald Sperlein +49.69.70730.906
VP-Senior Analyst
harald.sperlein@moodys.com

Massimo Visconti, MBA +39.02.9148.1124
VP-Sr Credit Officer/Manager
massimo.visconti@moodys.com

City of Zagreb (Croatia)

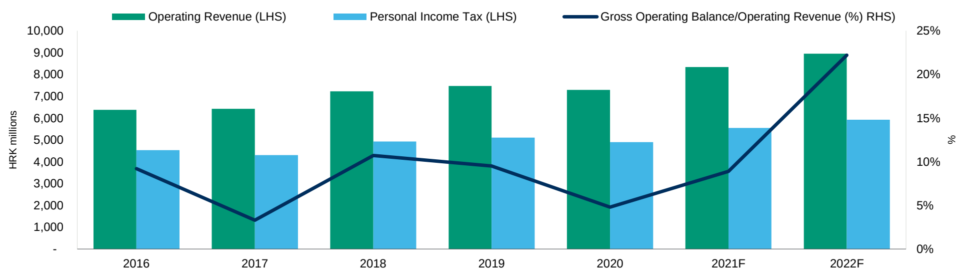
Update to credit analysis

Summary

The credit profile of the City of Zagreb (Ba1 stable) reflects its consistently prudent budgetary management, solid operating performance, low direct debt levels as well as a moderate likelihood that the Government of Croatia (Ba1 stable) will provide support if the city were to face acute liquidity stress. Other factors underpinning the ratings include Zagreb's large and well diversified local economy contributing to a tax revenue base with low volatility and positive growth prospects. Conversely, the rating incorporates the pressure stemming from the city's public services provider, Zagrebacki Holding D.O.O. (Ba1 stable) and the city's transportation company, Zagrebacki Elektricni Tramvaj (ZET)

Exhibit 1

Improving operating performance in 2021-22 driven by tax revenue growth



F = Forecast
Source: City of Zagreb, Moody's Investors Service

Credit strengths

- Healthy operating performance fueled by growing tax revenues and strich cost control
- Satisfactory financing results, notwithstanding the damages from the earthquake
- Zagreb's wealthy economy and important role as the economic hub of Croatia

Credit challenges

- Increasing direct debt levels, but overall moderate and manageable
- High indirect exposure from city-owned companies
- Limited liquidity

Rating outlook

The stable outlook on Zagreb's rating mirrors the stable outlook on the sovereign bond rating. It also reflects our expectation that the city will be able to preserve its overall solid financial performance, supported by the central government, alleviating the pandemic- and earthquake-driven fiscal pressure. The city's history of prudent budgetary management further supports the stable outlook.

Factors that could lead to an upgrade

» Upward pressure on Zagreb's rating could emerge from an upgrade of the sovereign rating, with the maintenance of good financial performance and low direct debt levels.

Factors that could lead to a downgrade

» A deterioration in the sovereign credit strength could exert pressure on Zagreb's rating because of the close financial, institutional and operational links between the two tiers of governments.

» A sustained deterioration in the city's operating performance and a substantial increase in its debt and debt-servicing needs could also lead to a rating downgrade.

Key indicators

Exhibit 2

City of Zagreb

City of Zagreb

	2016	2017	2018	2019	2020	2021F	2022F
Net Direct and Indirect Debt/Operating Revenue (%)	109.6	104.4	70.7	70.8	109.7	101.0	88.0
Direct Debt/Operating Revenue (%)	23.6	23.4	24.0	27.1	33.2	32.4	25.9
Cash Financing Surplus (Requirement)/Total Revenue (%)	-3.9	-5.8	-4.1	-7.4	-5.1	-1.1	12.7
Gross Operating Balance/Operating Revenue (%)	9.2	3.3	10.7	9.5	4.8	8.9	22.2
Debt Service/Total Revenue (%)	5.1	6.8	5.3	8.0	9.8	11.0	10.3
Capital Expenditure/Total Expenditure (%)	13.3	10.7	14.9	16.3	11.8	12.0	17.2
Intergovernmental Transfers/Operating Revenue (%)	1.6	5.6	2.5	4.6	7.9	5.5	11.6

F = Forecast.
Source: City of Zagreb, Moody's Investors Service

Detailed credit considerations

The credit profile of the City of Zagreb, as expressed in its Ba1 stable rating, combines a Baseline Credit Assessment (BCA) of ba1 and a strong likelihood of extraordinary support from the national government in the event that the entity faces acute liquidity stress.

Baseline credit assessment

Healthy operating performance fueled by growing tax revenues

Zagreb's operating performance remained solid in 2020 despite adverse impact of coronavirus pandemic and economic contraction with gross operating balance (GOB) at 5% of operating revenue, which is below the last year operating result of 9.5%. The shared personal income tax (PIT) and surtax on PIT, which together constitute around 70% of the city's operating revenue, decreased by 4% in 2020, while fees, charges and other non-tax revenues declined by 16%. The drop in key operating revenue has tested Zagreb's traditionally prudent budgetary management as the city successfully kept operating spending growth in check through a combination of spending reviews and cost controls.

This year's extraordinary real gross domestic product (GDP) growth rate of 7.5% and above-national average local economy translates into growing proceeds from the income tax, which will support the city's improving GOB at around 9% of operating revenue. In 2022, we expect the city to post GOB levels in double-digit territory although we forecast GDP growth to be lower than this year. The growth in the operating margin will be achieved through a combination of solid growth of tax revenue (7% growth year-on-year) and continuation of tight control over the operating expenditures. The new mayor, Mr. Tomislav Tomasevic, elected in May 2021, supported by the majority in the City Council, has recently introduced a series of cost cutting measures, which were included in the adjusted budget for 2021 as well as in the 2022 budget adopted in December 2021.

Given the rigidity in Zagreb's operating spending, these measures will continue to focus primarily on containing the growth of costs of goods and services, and current transfers and subsidies. Costs for personnel, goods and services, along with the subsidies to city's transportation company ZET and donations for social programmes (representing a high 65%-70% of operating spending), limit the city's spending flexibility.

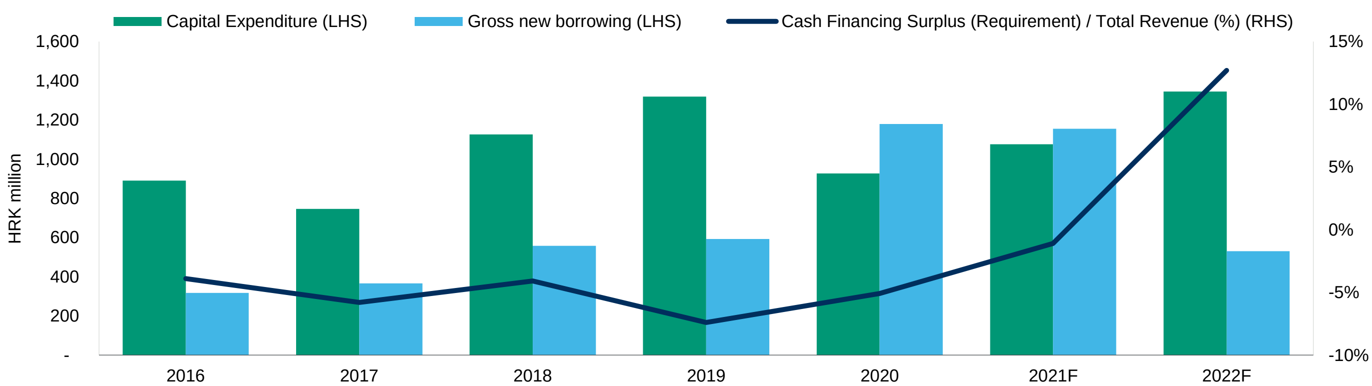
Satisfactory financing results, notwithstanding the damages from the earthquake

The adjustments of the capital spending has played a significant role in retaining a low financing deficit in 2020-21 as the city posted a deficit of 5.1% of total revenue in 2020 compared with 7.4% a year before. In accordance with the latest budget readjustments of September 2021, the city should post a small financing deficit of around 1% of projected total revenue (Exhibit 3).

Lower revenue generation experienced last year resulted in city's decision to scale down its capital expenditure, which accounted for 11.8% of total expenditures (14.5% on average over the last five years). Moreover, this indicates high capex flexibility, as some projects can be delayed or abandoned if required. The city has continued its cautious capital spending policy in 2021 by maintaining capital expenditures at last year level. The projections for 2022 envisage an increase in capital investments to 17% of forecasted total revenue, which may put moderate pressure on the city's finances.

Exhibit 3

Improving financing results despite high investment needs



F = Forecast.

Source: City of Zagreb, Moody's Investors Service

We expect Zagreb to continue making effective use of new EU funding opportunities offered in the 2021-2027 programming period, without exerting excessive pressure on its budget. This will diversify its funding sources for capital investment in 2022, with EU funds likely to account for about 25%-30% of the total capex. A further 30%-35% will come from the city's own operating balance and new borrowings will cover the remaining 40%.

The city will reevaluate its investment priorities following the damages caused by the earthquake. However, the capital spending plan focuses on infrastructure, including public transportation, road maintenance, social service facilities, healthcare, water supply and sewage, energy efficiency measures and solid waste treatment facilities.

As an EU member state, Croatia received financial aid from the EU Solidarity Fund amounting to €683.7 million (HRK5.1 billion) in November 2020, to alleviate the costs for reconstruction in the capital city and the surrounding area of Zagreb. The City of Zagreb has estimated an initial amount of HRK2.4 billion for co-funding from the EU Solidarity Plan for the restoration of earthquake damages. Although these grants will have neutral impact on the financial performance of the city given that they are earmarked for the earthquake affected infrastructure, this financial assistance will significantly reduce the pressure on Zagreb's finances and limiting its borrowing needs.

Zagreb's wealthy economy and important role as the economic hub of Croatia

Zagreb is the capital of Croatia and the country's largest city with 807,000 inhabitants (2019 latest available data), representing almost 20% of the national population. As the capital city, Zagreb contributes significantly to the country's economy, accounting for 34% of the national GDP. With local GDP per capita at 185% of the national average (data as of 2019), Zagreb is Croatia's wealthiest city. It is a home for one third of Croatia's businesses, which provide 32.5% of the country's total employment (data as of 2019). The city's unemployment rate was 4.6% as of year-end 2020, well below the national rate of 7.2%.

Zagreb benefits from a diversified industrial base, which includes food processing, machinery construction, petrochemicals and chemicals and the light industry. Zagreb is the seat of the central government and hosts the country's main universities and headquarters of Croatia's largest companies.

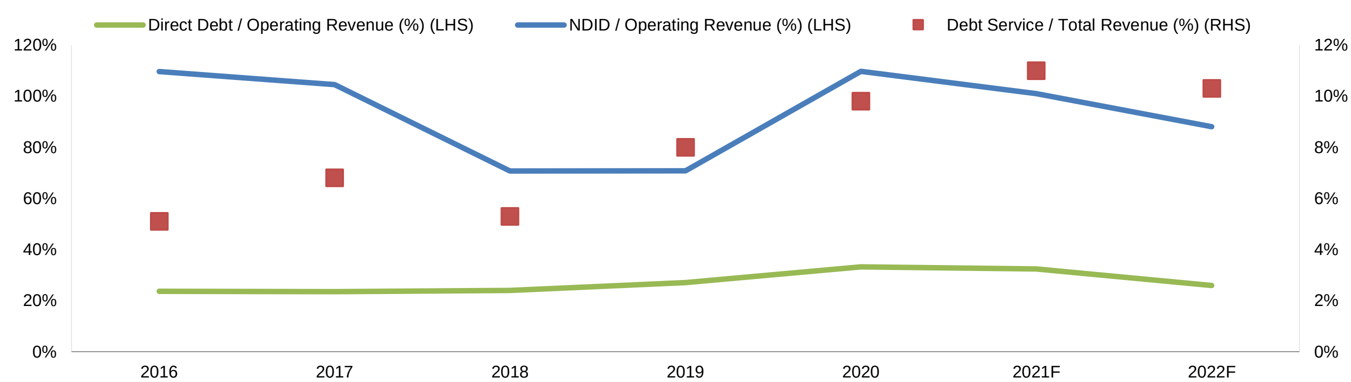
Increasing direct debt levels, but overall moderate and manageable

The city's direct debt increased to HRK2.4 billion, representing still a moderate 33% of operating revenue in 2020 compared with 27% a year before. The growth of city's direct debt was primarily driven by the interest free short-term facilities of HRK429.6 million at year-end 2020 granted by the Ministry of Finance for offsetting the coronavirus pandemic-induced revenue shock. In 2021, the city is planning to take on a new debt of HRK326.5 million to fund its infrastructure investments and energy efficiency projects.

We expect the city's direct debt levels to remain at around 32% of projected operating revenue in 2021 before declining to below 30% by 2022 (Exhibit 4). These debt levels are unlikely to change in the foreseeable future due to the constraints on debt imposed by the country's institutional framework. In addition, the European Union (EU) and the central government grants will help alleviate Zagreb's financing needs and limit new borrowings for infrastructure investments in 2021-22.

Exhibit 4

After increase debt levels will gradually decline in 2022



F = Forecast.
Source: City of Zagreb, Moody's Investors Service

The majority of Zagreb's debt is consisted of bank loans with domestic financial institutions that represent 45% of total direct debt, an additional 18.5% made up of commodity loans and 19% comprises unconventional debt instruments such as factoring deals. The remainder of 17.5% of total direct debt is represented by interest free loans provided by the Ministry of Finance.

The debt service related to Zagreb's direct debt increased to 9.8% of total revenue in 2020 from 8% a year before and will remain between 10% and 11% in 2021-22. Moody's considers these obligations as manageable given the city's healthy operating margins.

High indirect exposure from city-owned companies

When accounting for indirect debt, the city's net direct and indirect debt (NDID) mounted high 110% of operating revenue in 2020 before gradually declining to 101% at year-end 2021 and a further fall to 88% is expected in 2022. Zagreb's indirect exposure is represented by either city-guaranteed or unsecured debt of Zagrebacki Holding as well as the outstanding debt of the city transportation company ZET, both considered to be non-self supporting companies. The major businesses operated by the holding company and ZET are extremely important for the city and require its ongoing support, either in the form of operating or capital subsidies. Payments to these companies are among the main drivers of Zagreb's spending, accounting for about 15% of its budget.

The city's high indirect debt exposure is largely related to challenging operating environment the Holding company and ZET operated in during the pandemic period with the Holding company reporting a negative financing result after a few consecutive years of positive financial performance. The Holding company and its subsidiaries, were also negatively hit by the earthquake occurred in March 2020 that caused billions in damage in Zagreb, as the city and its owned companies took a decision to temporarily release the affected households and business from paying fees and charges for water, sewage, waste collection and gas.

We expect the level of guaranteed debt to increase to around HRK3.0 billion by year-end 2021 from HRK2.34 billion in 2019, representing 52% of the city's NDID projected this year. The increase is due to a new guarantees provided over the last 2 years. In particular, in April 2021, the city issued a guarantee of HRK400 million to water and sewage company VIO, a subsidiary company of Zagrebacki Holding to support its long-term water infrastructure investments, following the guarantee of HRK429.6 million the city issued to ZET in December 2019 for the completion of the cabin lift to Sljeme. The Holding company is considering to refinance the remaining portion of the city's guaranteed debt, which constitutes of HRK2.3 billion bullet bond due in 2023. Moody's views favourably statements from Zagreb's representatives to consider the holding company's debt as the city's indirect obligation, which is in line with Moody's approach.

The latest projections suggest that Holding's financial results will remain negative in 2021 before turning to positive in 2022 on the back of the restructuring and cost cutting measures to be introduced by the new management board elected in October 2021.

Notwithstanding the positive financing results, ZET will remain a continuous source of budgetary pressure on the city's budget, given the planned investments, in particular the renewal of its tram and bus fleet. Subsidies to ZET rose to HRK758 million in 2020, which is a year-on-year growth of 12.4% following the adjustments in the way the sector is financed. This amount includes the lease repayment of HRK60 million. The amount of subsidies paid by the city will continue to rise to HRK769 million in 2021. Since January 2018, when ZET spun off from Zagrebacki Holding and emerged as a limited liability company under the city's direct control, the level of subsidies is based on a new contract, which requires full compensation for public transportation service obligations as well as a fair level of profit (including depreciation).

The high companies' debt levels were also driven by investment projects in the utility and urban transport sectors that were financed through debt issued by Zagrebacki Holding and ZET. In 2021, the Holding and its subsidiaries are envisaging total investments of HRK663 million, of which 54% will be funded from new loans. ZET's ambitious investment programme in 2021 amounts HRK1.89 billion, of which HRK1.39 billion intended for purchasing of new buses and trams and associated transport infrastructure will be secured from the EU funds, with the remainder to be funded from the city's budget and own revenues.

Limited liquidity

Despite overall good financial performance, the City of Zagreb has historically held a limited level of cash reserves. The city's liquidity deteriorated further in 2020, averaging HRK55 million compared with HRK86 million one year before. The worsening of the liquidity was attributable to financing pressure stemming from earthquake as immediate funding of emergency services and infrastructure repairs squeezed the city's cash reserves.

Nevertheless, Zagreb's regular and predictable inflow and outflow throughout the year and its cash-generating capacity provide sufficient cash to cover the city's debt servicing requirements due in 2021 and 2022. The city follows a prudent cash management strategy, which, together with regular distributions of shared taxes, ensures smooth cash flow.

In addition, the city signed a new HRK400 million interest free loan with the Ministry of Finance in July 2021, which will additionally support the city's liquidity position. While we expect some volatility resulting from the negative effects of the earthquake and pandemic, we believe the city's liquidity will remain broadly stable.

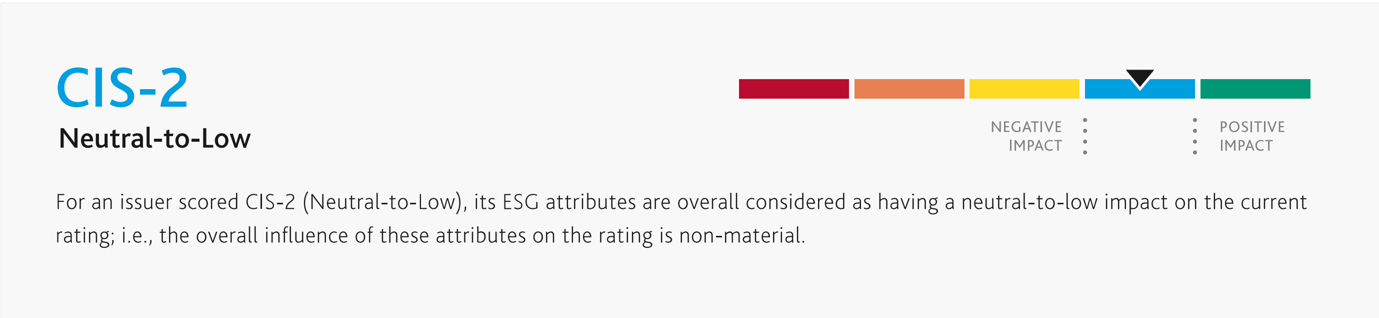
Extraordinary support considerations

We consider Zagreb to have a moderate likelihood of extraordinary support from the national government, reflecting our assessment of the city's strategic importance to the national economy. The system of oversight implemented by the national government requires regular monitoring of cities' indebtedness.

ESG considerations

City of Zagreb's ESG Credit Impact Score is Neutral-to-Low CIS-2.

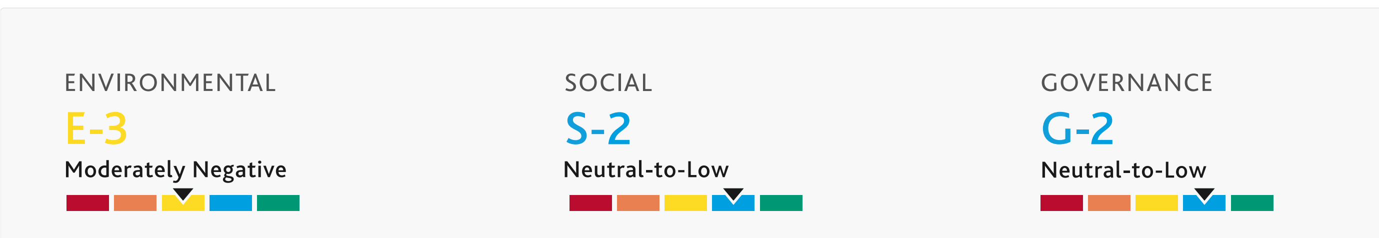
Exhibit 5
ESG Credit Impact Score



Source: Moody's Investors Service

Zagreb's ESG Credit Impact Score is neutral to low (**CIS-2**), reflecting moderate exposure to environmental and low exposure to social risks, while benefiting from the European integration is further enhancing the city's institutional and governance capacity.

Exhibit 6
ESG Issuer Profile Scores



Source: Moody's Investors Service

Environmental

Zagreb's overall E issuer profile score is assessed as moderately negative (**E-3**), reflecting moderate exposure to physical climate risks. Laying on the bank of Sava river, the city has some exposure to flood risk, but Zagreb has continuously taken measures to protect against floods. The City of Zagreb is responsible for investing in water and waste treatment facilities and reconstruction of sewerage system to improve the collection of water and storm water as well as waste thus raising the efficiency of the infrastructure and service provision.

Social

Zagreb's S issuer profile score is assessed as neutral to low (**S-2**). Zagreb is more exposed to net immigration flows. The unemployment rate in Zagreb is lower than the average for Croatia, and the average salary in Zagreb is higher than that in the remaining parts of the country. Access to education, health care facilities and provision of basic services are good.

Governance

Zagreb's solid institutions and governance strength is reflected in a neutral to low G issuer profile score (**G-2**). This is underpinned by the city's high credibility in managing its operations and development by using prudent financing planning, which allows for multiyear forecasting of key trends. Zagreb has an ability to identify potential pressures, allowing for sufficient time to adopt mitigation measures

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

All of these considerations are further discussed in the "Detailed credit considerations" section above. Our approach to ESG is explained in our report on how the scores depict limited impact of ESG factors in advanced economy RLGs, negative in emerging markets and our cross-sector methodology General Principles for Assessing Environmental, Social and Governance Risks Methodology.

Rating methodology and scorecard factors

The assigned BCA of ba1 is close to the scorecard-indicated BCA of ba2. The matrix-generated BCA of ba2 reflects an Idiosyncratic Risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and a Systemic Risk score of Ba1, as reflected in the sovereign bond rating of Croatia.

Exhibit 7

Zagreb, City of

Regional and Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals				**1**	**20%**	**0.20**
Economic Strength [1]	1	177.23%	70%			
Economic Volatility	1		30%			
Factor 2: Institutional Framework				**4**	**20%**	**0.80**
Legislative Background	5		50%			
Financial Flexibility	3		50%			
Factor 3: Financial Position				**4.25**	**30%**	**1.43**
Operating Margin [2]	3	7.02%	12.5%			
Interest Burden [3]	1	0.70%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	7	109.71%	25%			
Debt Structure [5]	9	45.94%	25%			
Factor 4: Governance and Management				**1**	**30%**	**0.30**
Risk Controls and Financial Management	1					
Investment and Debt Management	1					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**2.73 (3)**
Systemic Risk Assessment						**Ba1**
Suggested BCA						**ba2**

[1] Local GDP per capita as % of national GDP per capita
[2] Gross operating balance/operating revenues
[3] Interest payments/operating revenues
[4] Net direct and indirect debt/operating revenues
[5] Short-term direct debt/total direct debt
Source: Moody's Investors Service; Fiscal 2020.

Ratings

Exhibit 8

Category	Moody's Rating
ZAGREB, CITY OF	
Outlook	Stable
Issuer Rating	Ba1

Source: Moody's Investors Service

REPORT NUMBER 1312856

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S
PUBLIC SECTOR EUROPE