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Research Update:

Croatian City of Zagreb Affirmed At 'BB'; Outlook Stable

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Overview

- We believe the city of Zagreb will maintain strong operating margins, despite a tax revenue decrease and accrued deficit in 2017.
- In our view, the volatile institutional framework and weak liquidity coverage will constrain Zagreb's creditworthiness in the medium term.
- We are affirming our 'BB' long-term issuer credit rating on Zagreb.
- The outlook is stable.

Rating Action

On Sept. 28, 2018, S&P Global Ratings affirmed its 'BB' long-term issuer credit rating on the Croatian city of Zagreb. The outlook is stable.

Outlook

The stable outlook on Zagreb reflects our view that persistent strong operating balances, as well as asset disposals, will counterbalance Zagreb's increased investment plans and limit substantial debt accumulation. We also anticipate the city will retain its current liquidity levels.

Downside scenario

We could downgrade Zagreb if the city's financial profile worsened, with contracting operating margins or increased debt. We would also consider lowering the rating if we saw continued pressure on the city's cash levels, resulting in accumulation of payables or a further fall in cash holdings.

Upside scenario

We could raise the rating if the city structurally improved its liquidity position, resulting in cash and funds available under credit facilities covering yearly debt service sustainably by more than 80%. Additionally, stronger medium- and long-term planning, coupled with strict oversight of municipal companies, could enhance our view of the city's financial management and intrinsic creditworthiness.

Rationale

The rating reflects our view that the city's operating balance will remain high, but slowly decline. This, together with asset disposals and capital grants, will allow room for more rapid investments and for paying off part of the accumulated accrued deficit of 2017. As a result, we believe debt accumulation will be limited and the weak liquidity position will not deteriorate any further.

However, burdening the rating is the volatile institutional framework that is subject to relatively frequent changes. This may cause revenue and expenditure mismatches and pressure financial management and policies.

The institutional framework and financial management limit Zagreb's creditworthiness

In our view, Zagreb's creditworthiness remains constrained by the institutional setup under which Croatian municipalities operate. The framework changes frequently and the distribution of resources is unbalanced and not sufficiently aligned to tasks delegated to municipalities. This is exemplified by the multiple changes to the tax system introduced during 2017-2018. For example, the personal income tax reform, aimed at easing the tax burden for individuals and companies, reduced the maximum rate for personal income tax to 36% from 40%. This effectively diminishes Zagreb's tax income and revenue-raising abilities. The measure is marginally compensated by an increase in the distribution coefficient in 2018. However, the much-awaited introduction of a single property tax, to replace several local taxes and fees, was eventually cancelled. Nonetheless, the central government will indemnify revenue shortfalls that result from the new income tax regime, through transfers. These transfers have a ceiling mirroring 2016 income tax revenues, and are set to diminish starting from 2021. Further tax cuts proposed by the Ministry of Finance in August 2018 might put additional pressure on Zagreb's operating performance. As a result, the unpredictability of the central government's actions constrains policy effectiveness at the city level, limiting Zagreb's ability to effectively plan for the long term.

Milan Bandic is currently serving his sixth term as mayor, indicating some stability in the city's political management. Nonetheless, we see the management's effectiveness as constrained by unreliable long-term planning and weak liquidity policies. In addition, the use of unconventional debt instruments such as factoring deals, and the sometimes difficult relationship between the government and city assembly, further limit our management assessment.

The city's oversight and control over municipal companies remains weak overall. The board of municipal company Zagrebacki Holding maintains very close ties with the city's management, although clear decision-making procedures appear to be lacking. In late 2017, both the transportation company (ZET) and the fair company (Zagrebacki Velesajam) were spun off from the holding company and placed under the city's direct control. This restructuring was to enhance funding and grant sources via European institutions, and to allow for tighter control of the loss-making transport company.

The city alone contributes about one-third of total Croatian GDP, and unemployment has been steadily decreasing (5.9% as of January 2018). Due to Zagreb's dependence on central government tax revenue distribution, we use the country's national GDP per capita as the starting point for our assessment of Zagreb's economic profile. We forecast a national GDP per capita of about $14,500 in 2018, an average level compared with that of international peers. The pull the city exerts has resulted in a growing population, in contrast to the national trend. This supports the city's economic and tax base to some degree. In 2016, the city's population increased to about 802,300, 19% of Croatia's total population in 2016. Furthermore, the city's management continues to focus on projects intended to promote Zagreb further as a tourist and international conference destination. In our view, these strengths reflect a highly diversified local economy.

Operating surpluses will remain strong, helping keep debt low and limiting the risks from weak liquidity

We expect Zagreb will exhibit positive, albeit declining, operating balances of 9%-11% in 2018-2020, supported by solid underlying economic growth. However, this is partially offset by contained tax revenue growth and uncertainties regarding tax legislation.

In our view, Zagreb's budgetary flexibility is weak. Personal income tax, which accounts for about two-thirds of the city's operating revenues, cannot be modified by the city, except for the surtax charged. In addition, the tax reform introduced in 2017 effectively decreased tax brackets and increased the number of taxpayers exempt from the surtax of 18%. As a result, the city is largely dependent on the central government regarding taxation matters. Personnel, combined with goods and services expenses, represented 38% of Zagreb's operating expenditure in 2017, limiting the city's expenditure flexibility. This is exacerbated by large inflexible subsidies granted to the municipal holding company, and the now stand-alone ZET, which both support the city in the supply of essential public services.

Zagreb's capital program targets transportation infrastructure, street renovations, and social service facilities. Notably, the city is concentrating its resources on bridge renovation and the reconstruction of one of the largest and busiest junctions. Capital expenditure (capex) represents approximately 10% of total expenditure in 2018-2020 and we forecast it will average about Croatian kuna (HRK) 700 million per year over that period (total of approximately HRK2.2 billion). This, in turn, results in expected surpluses after capital accounts decreasing to an average of 0.7% in 2019-2020, from about 5% in 2018, as capex increases in the later years of our forecast. This is also in line with observations from the previous EU program, whereby fund utilization picks up toward the end of the cycle.

The city's strong operating surpluses should help limit debt accumulation over the coming years, as well as pay off the deficit recorded in 2017. After a net debt repayment in 2018, we forecast moderately rising net new borrowing, both at the city level and at Zagrebacki Holding. On the basis of new data received from the city, we revised our estimate of tax-supported debt in 2017 down to about HRK7.3 billion, but this had no impact on our assessment of the city's debt.

In our base-case scenario, we assume that the city's tax-supported debt, which includes debt of other municipal companies and Zagrebacki Holding, will increase to 74% of consolidated operating revenues in 2020 from 70% in 2018. In our view, this is high relative to that of peers in the region, but is generally neutral to Zagreb's creditworthiness, which is supported by high operating margins. We forecast direct debt, which includes the factoring deals the city services on behalf of Zagrebacki Holding, will decline in 2018. However, to support capex and the 2017 deficit repayment, we expect a moderate increase to about HRK2 billion in 2020 (about 28% of operating revenues) from about HRK1.8 billion in 2018.

Zagreb's available liquidity remains limited, with a debt-service coverage ratio of about 38% over the coming 12 months. Zagreb's cash holdings average HRK85 million per month; we factor into our assessment maturing debt liabilities, factoring deals, and guarantee payments. Additionally, we view access to external liquidity as limited, since Croatia's domestic banking sector is relatively weak, as reflected in our assessment of the banking sector (see "Banking Industry Country Risk Assessment: Croatia," published Jan. 16, 2017, on RatingsDirect).

In our view, Zagreb's contingent liabilities remain moderate. We factor in Zagrebacki Holding's and ZET's payables, as well as the long-term and short-term debt of self-supporting entities, in analyzing the city's total exposure. The city also recently received an unfavorable ruling in a legal case against the Ministry of Finance. However, it is likely that the parties will agree on a settlement. Overall, we estimate that the maximum loss under a stress scenario would be 10%-15% of operating revenues.

Key Statistics

Table 1

City of Zagreb Key Statistics

	--Fiscal Year End Dec. 31--					
(Mil. HRK)	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**
Operating revenues	6,161	6,376	6,420	6,825	6,984	7,140
Operating expenditures	5,471	5,696	6,007	6,064	6,279	6,490
Operating balance	690	680	413	761	705	650
Operating balance (% of operating revenues)	11.2	10.7	6.4	11.2	10.1	9.1

Table 1

City of Zagreb Key Statistics (cont.)

	--Fiscal Year End Dec. 31--					
(Mil. HRK)	**2015**	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**
Capital revenues	46	51	152	280	147	130
Capital expenditures	409	750	630	670	769	768
Balance after capital accounts	327	(19)	(65)	371	83	12
Balance after capital accounts (% of total revenues)	5.3	(0.3)	(1.0)	5.2	1.2	0.2
Debt repaid	518	525	689	397	322	354
Gross borrowings	193	444	366	50	350	450
Balance after borrowings	2	(100)	(388)	28	111	108
Modifiable revenues (% of operating revenues)	23.8	38.3	35.0	34.0	33.9	33.8
Capital expenditures (% of total expenditures)	7.0	11.6	9.5	10.0	10.9	10.6
Direct debt (outstanding at year-end)	2,681	2,436	2,197	1,839	1,901	2,012
Direct debt (% of operating revenues)	43.5	38.2	34.2	27.0	27.2	28.2
Tax-supported debt (outstanding at year-end)	9,089	8,982	7,292	7,204	7,566	7,977
Tax-supported debt (% of consolidated operating revenues)	97.7	93.7	69.4	69.9	72.2	73.7
Interest (% of operating revenues)	1.9	1.6	1.3	1.2	0.8	0.9
Local GDP per capita (HRK)	141,379	147,188	153,350	160,015	167,301	174,748
National GDP per capita (HRK)	80,784	84,176	88,641	93,044	97,568	101,810

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. dc--Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. uc—Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. HRK--Croatian kuna.

Ratings Score Snapshot

Table 2

City of Zagreb Ratings Score Snapshot

Key rating factors	
Institutional framework	Volatile and unbalanced
Economy	Average
Financial management	Weak
Budgetary flexibility	Weak
Budgetary performance	Very strong
Liquidity	Weak
Debt burden	Low
Contingent liabilities	Moderate

*S&P Global Ratings' credit ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments" summarizes how the eight factors are combined to derive the foreign currency rating on the government.

Key Sovereign Statistics

- Croatia Outlook Revised To Positive On Strengthening Fiscal And Economic Performance; 'BB+/B' Ratings Affirmed, Sept. 21, 2018

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Sovereign Risk Indicators, July 5, 2018. An interactive version is also available at http://www.spratings.com/sri
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Sept. 21, 2017
- Institutional Framework For Croatian Municipalities Remains Volatile And Unbalanced, Jan. 18, 2017
- Banking Industry Country Risk Assessment: Croatia, Jan. 16, 2017

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Ratings Affirmed

Zagreb (City of)	
Issuer Credit Rating	BB/Stable/--

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.