

Research Update:

City of Zagreb Outlook Revised To Stable From Negative On Economic And Fiscal Rebound; 'BB-' Rating Affirmed

September 24, 2021

Overview

- We expect the Croatian economy to rebound significantly after the pandemic-related recession in 2020, increasing Zagreb's revenue.
- The new management team implemented various policy changes aiming to strengthen the city's budgetary performance and liquidity, and transparency of city holdings.
- Drawings on Zagreb's share in reconstruction costs after devastating earthquakes are very low so far, but will continue to weigh on the city's financial situation for years, in our view.
- We therefore revised our outlook to stable from negative and affirmed our 'BB-' long-term issuer credit rating on Zagreb.

Rating Action

On Sept. 24, 2021, S&P Global Ratings revised its outlook to stable from negative and affirmed its 'BB-' long-term issuer credit rating on the Croatian capital city of Zagreb.

Outlook

We base the stable outlook on our expectation that Zagreb will continue to consolidate its budgetary performance with the help of increased revenue collection and a tight grip on expenditure. We believe that the ongoing reconstruction of earthquake-devasted areas should not lead to significant funding gaps for the city.

Downside scenario

We could lower the rating if, contrary to our expectation, the financial pressure on Zagreb and its companies would rise, for example if additional payables are accumulated and the cash holdings

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deteriorate. In addition, fading government support in channeling funds to the city to finance major investment projects could weigh on the rating.

Upside scenario

We see upward potential for the rating if Zagreb further reduces its contingent liabilities and increases transparency about the city's financial planning. In addition, an improving budgetary performance, further increased cash holdings, and the debt burden staying at current levels could provide uplift to the ratings.

Rationale

Our ratings on Zagreb reflect the city's strained liquidity, moderately high tax-supported debt burden, and volatile policy environment. These weaknesses are partly mitigated by the support Zagreb will receive from the EU and the central government to rebuild infrastructure after earthquakes in 2020. The amount and timing of government aid depends on the works' progress and bureaucratic dealings with various stakeholders. Although the city is likely to face fewer costs than initially thought, we continue to include in our assessment that Zagreb will have to cover some reconstruction costs, which will fall due over years, if not decades. We continue to view the city as dependent on support from capital inflow from EU funds and having good cooperation with the central government.

In our updated economic forecast for Croatia, we expect a sound rebound of the national economy with real GDP expanding by 6.5% in 2021, which should create additional tax revenue for Zagreb. We note a policy shift in the city administration following municipal elections in spring 2021. The new mayor, supported by a two-party coalition with the majority of seats in the city council, initiated consolidation measures in summer 2021, including the merger of city departments and reduction in salaries. The new management also announced steps to increase the transparency of city financials and decisions, and installed a new management board at main government-related entities, including Zagrebacki Holding d.o.o., which we view positively as first steps to consolidating city finances. In our base-case scenario for 2021-2023, continued investment needs will continue to create pressures on Zagreb's budgetary performance.

The rating on the city also considers our view of the unpredictable institutional framework for Croatian local and regional governments.

Zagreb depends on ongoing support from central government as well as EU funds

Zagreb's credit quality is limited by the institutional setup under which Croatian municipalities operate. The framework changes frequently, and the distribution of resources is unbalanced and insufficiently aligned to tasks delegated to municipalities. This is highlighted by Zagreb's accrued deficit, which reflects the funds the city expects to receive from the central government to compensate for delegated tasks. In addition, multiple changes to the tax system make financial planning difficult. For example, tax cuts at the central government level, aimed at supporting the local economy after the COVID-19 shock, would have led to considerable tax-shortfalls at Zagreb if the city hadn't reached an agreement with the central government. Zagreb has settled various legal disputes with the Croatian ministry of finance recently, somewhat limiting the litigation risks it is facing. It remains to be seen how the cooperation between the city administration and central government will develop over the next four years, especially because Zagreb is now ruled by

parties which are in opposition role at the national level.

Mayor Tomislav Tomasevic, elected in May 2021, has formed coalition granting him a majority in the city council. We understand that the new management team wants to alter city politics to increase financial transparency. In addition, the city established a new board of directors in its main municipal company, Zagrebacki Holding, and established a liquidity policy to raise minimum cash holding targets at the city level. The low predictability about when Zagreb will receive funds to cover earthquake-related costs constrains policy effectiveness and effective financial planning at the city level.

Zagreb benefits from its role as Croatia's capital and dominant economic center. The city contributes about one-third of total Croatian GDP. Unemployment is considerably lower than nationwide, reaching 4.6% as of year-end 2020, which we regard as low considering the pandemic-induced recession. GDP per capita is comparable with that of similarly rated international peers and about 70% higher than the national average. We expect Croatia's GDP growth to rebound by about 6.5% in 2021 and 5.0% in 2022, up from our previous forecast in spring 2021. We believe Zagreb's GDP per capita will develop similarly to national growth trends. Moreover, the pull Zagreb exerts on the country has resulted in a stable population, which positively distinguishes the city from the national trend. This will somewhat support the economic and tax base in the medium term.

Funds from the EU will help post-earthquake reconstruction, but the timing remains uncertain

Croatia will receive Croatian kuna (HRK) 5.1 billion from the EU Solidarity Fund to alleviate the costs of rebuilding infrastructure in Zagreb after two earthquakes in March 2020. The city will have access to HRK2.6 billion of this fund at some point until 2022, but we have not factored this support into our base-case scenario because the timing remains vague. The funding is designed to cover corresponding capital expenditure, and therefore should be neutral to overall budgetary performance. The availability of these funds could expire if they are not spent on the intended purpose and within a certain timeframe.

According to national law, local governments--which effectively means the City of Zagreb--need to cover 20% of the costs to rebuild the more heavily damaged private buildings. The magnitude of these costs is hard to estimate. Also, the reconstruction efforts will last at least a decade. Initial cost estimates are around HRK87 billion. Although the amount Zagreb will bear is impossible to predict, we assume that the costs for the city will be lower than originally expected. The state and the EU will finance most of the reconstruction of public buildings and infrastructure, while the city will cover a much smaller amount. The city has budgeted for HRK80 million in 2021 for this purpose, but only spent a tiny fraction of this due to slow reconstruction progress.

In our base-case scenario for 2021, we expect Zagreb to improve its operating balance due to recovering tax revenue and increased cost-cutting measures, including salary cuts for senior city management and fewer office departments. We therefore expect the city to achieve a lower deficit after capital accounts in 2021, and some small surpluses in the years thereafter.

Zagreb's budgetary flexibility is limited because most revenue items depend on the central government's decisions, and expenditure items like salaries tends to be rigid. The city cannot change its main revenue source, personal income taxes, except for the surtax charged. However, the latter is already at the maximum set by the central government. Expenditure flexibility is further constrained by fixed subsidies granted to the municipal holding company and Zagrebacki Elektricni Tramvaj (ZET); both supply essential public services. Asset sales have proven difficult in

recent years and do not provide additional room to maneuver.

At 95% of consolidated operating revenue in 2021, we regard Zagreb's tax-supported debt burden as moderate in an international comparison, but high for a local government in the Central and Eastern Europe region. Direct debt is less than half the tax-supported debt, reflecting the large outsourcing of debt via factoring deals and funding through various municipal companies to circumvent debt-financing rules. We assume Zagreb will accumulate debt in addition to financing needs years to help cover recent deficits. We therefore forecast rising net new borrowing, which the city also uses to replenish cash holdings. We assume that Zagreb's debt ratio, which includes debt of Zagrebacki Holding and other municipal companies, peaked in 2020 and will gradually decline over our forecast period thanks to an increasing budget size. Zagreb's debt burden is exacerbated by its large contingent liabilities, consisting of Zagreb's share of earthquake damages and litigations. We also factor in Zagrebacki Holding's and ZET's payables, as well as the long- and short-term debt of related entities not already included in tax-supported debt. Foreign exchange risk is limited because all debt is in local currency.

Zagreb's liquidity situation remains a key credit weakness. Despite increased cash holdings by mid-2021 and a newly established minimum cash level, cash on hand covers only about half of the next 12 months' debt service and financing needs. Also, we view access to external liquidity as limited because Croatia's domestic banking sector is relatively weak, in our view (see "Banking Industry Country Risk Assessment: Croatia," published Oct. 15, 2020, on RatingsDirect).

Key Statistics

Table 1

City of Zagreb--Selected Indicators

(Mil. HRK)	--Fiscal year ended Dec. 31--					
	2018	2019	2020	2021bc	2022bc	2023bc
Operating revenue	7,223	7,471	7,154	7,726	8,069	8,356
Operating expenditure	6,456	6,676	6,848	7,098	7,348	7,598
Operating balance	767	795	306	628	721	758
Operating balance (% of operating revenue)	10.6	10.6	4.3	8.1	8.9	9.1
Capital revenue	57	158	178	200	250	250
Capital expenditure	838	1,054	787	907	893	898
Balance after capital accounts	(14)	(102)	(304)	(79)	78	110
Balance after capital accounts (% of total revenue)	(0.2)	(1.3)	(4.1)	(1.0)	0.9	1.3
Debt repaid	551	671	794	443	487	451
Gross borrowings	558	593	1,336	804	690	642
Balance after borrowings	0	(180)	239	281	281	301
Direct debt (outstanding at year-end)	2,302	2,246	2,551	2,992	3,115	3,306
Direct debt (% of operating revenue)	31.9	30.1	35.7	38.7	38.6	39.6
Tax-supported debt (outstanding at year-end)	7,153	8,931	9,911	10,352	10,475	10,666
Tax-supported debt (% of consolidated operating revenue)	78.4	82.5	96.4	95.4	93.6	92.9

Table 1

City of Zagreb--Selected Indicators (cont.)

(Mil. HRK)	--Fiscal year ended Dec. 31--					
	2018	2019	2020	2021bc	2022bc	2023bc
Interest (% of operating revenue)	1.5	0.7	0.6	0.5	0.4	0.2
Local GDP per capita (HRK)	164,190	170,831	157,589	180,596	193,599	203,473
National GDP per capita (HRK)	94,270	98,975	91,801	99,923	107,022	112,650

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. HRK--Croatian kuna.

Ratings Score Snapshot

Table 2

City of Zagreb--Ratings Score Snapshot

Key ratings factor	Score
Institutional framework	5
Economy	3
Financial management	4
Budgetary performance	3
Liquidity	5
Debt burden	4
Stand-alone credit profile	bb-
Issuer credit rating	BB-

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, July 12, 2021. Interactive version available at <http://www.spratings.com/sri>

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Croatia 'BBB-/A-3' Ratings Affirmed; Outlook Stable, Sept. 17, 2021
- Comparative Statistics: European Local And Regional Government Risk Indicators, Sept. 1, 2021
- Economic Outlook Europe Q3 2021: The Grand Reopening, June 24, 2021
- City of Zagreb 'BB-' Rating Affirmed; Outlook Remains Negative, March 26, 2021
- Local Government Debt 2021: Global Borrowing To Hit \$2.25 Trillion, March 25, 2021
- Economic Research: Orderly Global Reflation Will Support The Recovery From COVID-19, March 22, 2021
- Default, Transition, and Recovery: 2019 Annual International Public Finance Default And Rating Transition Study, Dec. 8, 2020
- Banking Industry Country Risk Assessment: Croatia, Oct. 15, 2020
- Croatia-Based Zagrebacki Holding Rating Lowered To 'B-' From 'B+' Following Downgrade Of City Of Zagreb; Outlook Stable, Oct. 1, 2020
- Croatia BICRA Economic Risk Trend Now Negative On Deepening COVID-19 Risks; No Ratings Affected, May 19, 2020

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; Outlook Action

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

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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.

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