

Research Update:

City of Zagreb 'BB-' Rating Affirmed; Outlook Remains Negative

March 26, 2021

Overview

- The city of Zagreb's share of reconstruction costs related to the March 2020 earthquakes will likely be somewhat lower than originally anticipated.
- That said, we expect prolonged COVID-19-related shortfalls in tax revenue will result in a weaker-than-expected operating performance in 2021-2023.
- We therefore affirmed our 'BB-' long-term issuer credit rating on Zagreb and maintained the negative outlook.

Rating Action

On March 26, 2021, S&P Global Ratings affirmed its 'BB-' long-term issuer credit rating on the Croatian capital city of Zagreb. The outlook is negative.

Outlook

The negative outlook reflects our view that persisting strain on revenue might keep Zagreb from beginning the necessary reconstruction of its city center following the March 2020 earthquake. In our view, central government support remains unclear, including the timing of when the city will have access to the funds for the repair work.

Downside scenario

We could lower the rating in the next 12 months if the financial pressure on the city and its companies continues to rise, accelerating the accumulation of payables and deteriorating the cash position amid fading government support after the upcoming municipal elections.

Upside scenario

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We would revise the outlook to stable within the next 12 months if Zagreb regains financial flexibility. This would materialize as, for example, stable budgetary performance and stronger cash holdings, or reduced contingent liabilities.

Rationale

COVID-19 fallout and the March 2020 earthquakes have hit Zagreb hard financially and economically. Operational performance in 2020 deteriorated beyond our previous expectations, and the city reported higher-than-anticipated debt levels. In our base case for 2021-2023, ongoing tax shortfalls will continue to create budgetary deficits. However, we now include in our estimates a lower amount of contingent liabilities. This is because we expect Zagreb will receive funds from the EU and the central government to rebuild infrastructure after the earthquakes, even though the amount and timing of government support has yet to be determined. In addition, we currently estimate that the city will have to cover a markedly smaller share of the reconstruction costs than we initially expected.

That said, Zagreb plans to repay payables from its municipal companies in 2021 and fund its deficits with new borrowings. This will increase debt as well as transparency about the city's financial liabilities. Our rating on Zagreb takes into account our view of the city's very weak liquidity, volatile policy environment, and unpredictable institutional framework for Croatian local and regional governments.

Volatile institutional framework and low visibility on the city's financial plans constrain creditworthiness

In our view, 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 in compensation for delegated tasks. In addition, multiple changes to the tax system make financial planning difficult. However, we acknowledge that the city has reached an agreement with the central government to fund the Croatian municipal equalization system. Under the new agreement, the city will be relieved from the cost of the central government's tax rate cuts in 2021. Furthermore, the city will receive new leadership after the elections scheduled for early summer 2021; the long-serving mayor Mr. Milan Bandic unexpectedly died at the end of February 2021. So far, the transition to a new acting mayor, a former deputy mayor, has been smooth. But it remains to be seen how the city's financial policies will evolve with the new leadership.

We view Zagreb's unreliable long-term planning and lack of minimum cash holding targets as key management weaknesses. In addition, the use of unconventional debt instruments, such as factoring deals, and the sometimes-difficult relationship between the government and city assembly further hinders management's effectivity, in our view. We assess Zagreb's oversight and control over municipal companies as weak, since municipal companies, including but not limited to Zagrebacki Holding d.o.o., seemingly lack clear decision-making frameworks and continue to depend on the city for support. The unpredictability of the central government's actions constrains policy effectiveness at the city level, limiting Zagreb's ability to plan effectively. The city's three major expenditures are education, health care, and maintenance of public space.

Zagreb benefits from its role as Croatia's economic center. The city contributes about one-third of total Croatian GDP. Additionally, unemployment has been decreasing, having reached well below

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the national level of 7.1% in 2020, although levels might rise following the recession in 2020. GDP per capita is comparable with that of similarly rated international peers, while about 70% higher than the national average. We expect Croatia's GDP growth to rebound to more than 5% in 2021 and 3% in 2022, after the estimated contraction of about 8% in 2020 due to COVID-19-related impacts on tourism and consumption. 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 growing population, in contrast to the national trend. This will support the city's economic and tax base to some degree in the medium term.

EU funds via the central government will help fund post-earthquake reconstruction

Croatia will receive Croatian kuna (HRK) 5.1 billion from the EU Solidarity Fund to alleviate the costs of rebuilding infrastructure in Zagreb after the two earthquakes in March 2020. The city will have access to HRK2.6 billion of this fund at some point in 2021, but we have not factored this support into our base case since the timing remains vague. Nevertheless, these funds should help the city cover a large part of the works over the next few years. In early September 2020, the national parliament passed a law stipulating that local governments will need to cover 20% of the cost to rebuild the more heavily damaged private buildings. The magnitude of these costs is hard to estimate at this time. We also acknowledge that the reconstruction efforts will last at least a decade. Currently, the total cost of the needed reconstruction is estimated at about HRK87 billion. Although the amount that Zagreb will have to bear cannot be accurately estimated at this time, we assume that the costs for the city will be lower than originally expected. The state will finance most of the reconstruction of public buildings and infrastructure, while the city will cover a much smaller amount. Additional earthquakes occurred in December 2020 and January 2021 south of Zagreb, but we understand that the capital city did not suffer any serious damage.

Although we expect the economy to recover in 2021, tourism and economic activity will most likely remain subdued until the second half of the year. This will create additional tax shortfalls in 2021 following an already weak 2020. Last year's operating balance as a percentage of operating revenue more than halved on a year-to-year basis. Also, we expect that tax losses following the economic recession will not be fully covered by the central government, resulting in an operating balance of 7%-8% of operating revenue in 2021-2023, compared with nearly 11% in 2018-2019. We also note that the central government has implemented a tax reform and reduced personal income tax rates this year, and that Zagreb will be largely compensated through the reduction of other state-delegated expenditure.

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. Expenditure flexibility is further constrained by large fixed subsidies granted to the municipal holding company and the now stand-alone Zagrebacki Elektricni Tramvaj (ZET); both support the city in the supply of essential public services. Asset sales have proven difficult in recent years and do not provide additional room to maneuver. We assume that the outsourced entities will debt-finance revenue shortfalls due to fee freezes and fewer ticket sales following quarantine measures.

Direct debt is less than half the tax-supported debt, reflecting the large outsourcing of debt via factoring deals and funding via various municipal companies to circumvent debt financing rules. In 2020, tax-supported debt surpassed 90% of consolidated revenue, which is moderate in an international comparison, but much higher than for peers in the region. We assume Zagreb will

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accumulate debt in addition to financing needs over the coming years to help pay off the deficit accumulated over the past years. We therefore forecast rising net new borrowing, both at the city level and at Zagrebacki Holding. We assume that the city'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. In the past, this was somewhat mitigated by Zagreb's relatively high operating margins, which is no longer the case.

Zagreb's high debt burden is exacerbated by its large contingent liabilities, consisting of Zagreb's share of earthquake damages and litigations, which we continue to consider as high. 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, which the city intends to partly pay off in 2021.

Zagreb's liquidity situation remains a key credit weakness. Available liquidity is limited, with Zagreb's cash holdings at a low HRK21 million at end-2020. We do not anticipate a change and believe there isn't enough cash to cover the next 12 months of debt service or upcoming deficits. Also, we view access to external liquidity as very 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

	2018	2019	2020	2021bc	2022bc	2023bc
Operating revenues	7,223	7,471	7,154	7,626	7,969	8,256
Operating expenditures	6,456	6,676	6,848	7,098	7,348	7,598
Operating balance	767	795	306	528	621	658
Operating balance (% of operating revenues)	10.6	10.6	4.3	6.9	7.8	8.0
Capital revenues	57	158	178	200	200	200
Capital expenditures	838	1,054	787	907	893	898
Balance after capital accounts	(14)	(102)	(304)	(179)	(72)	(40)
Balance after capital accounts (% of total revenues)	(0.2)	(1.3)	(4.1)	(2.3)	(0.9)	(0.5)
Debt repaid	551	671	794	1,283	487	451
Gross borrowings	558	593	1,336	1,462	559	491
Balance after borrowings	0	(180)	239	0	0	0
Direct debt (outstanding at year-end)	2,302	2,246	2,787	2,879	2,864	2,817
Direct debt (% of operating revenues)	31.9	30.1	39.0	37.8	35.9	34.1
Tax-supported debt (outstanding at year-end)	7,153	8,931	9,472	9,565	9,550	9,503
Tax-supported debt (% of consolidated operating revenues)	78.4	82.5	90.1	87.1	84.3	81.8
Interest (% of operating revenues)	1.5	0.7	0.6	0.6	0.6	0.5
Local GDP per capita (single units)	159,057	163,670	165,837	172,881	180,048	187,513

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Table 1

City of Zagreb Selected Indicators (cont.)

	2018	2019	2020	2021bc	2022bc	2023bc
National GDP per capita (single units)	94,270	98,976	91,467	97,287	102,307	106,965

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.

Ratings Score Snapshot

City of Zagreb Ratings Score Snapshot

Table 2

Key rating factors	Scores
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, Dec 14, 2020. An interactive version is available at 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

- Local Government Debt 2021: Global Borrowing To Hit \$2.25 Trillion, March 25, 2021
- Economic Outlook Europe Q2 2021: The Path To A Strong Restart, March 25, 2021
- Sovereign Debt 2021: Developed EMEA's Commercial Borrowing Could Reach \$1.4 Trillion, March 1, 2021
- Economic Research: European Economic Snapshots: Policy Is Keeping The Impact Of The Second COVID Wave At Bay, Dec. 16, 2020
- 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
- City of Zagreb Downgraded To 'BB-' On Reconstruction Costs; Outlook Negative, Sept. 25, 2020
- Croatia 'BBB-/A-3' Ratings Affirmed; Outlook Stable, Sept. 18, 2020
- Comparative Statistics: European Local And Regional Government Risk Indicators, June 30, 2020
- Croatia BICRA Economic Risk Trend Now Negative On Deepening COVID-19 Risks; No Ratings Affected, May 19, 2020

Ratings List

Ratings Affirmed

Zagreb (City of)

Issuer Credit Rating 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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