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CREDIT OPINION
25 July 2022

Update

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RATINGS

Zagreb, City of

Domicile	Zagreb, Croatia
Long Term Rating	Baa2
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.

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City of Zagreb (Croatia)

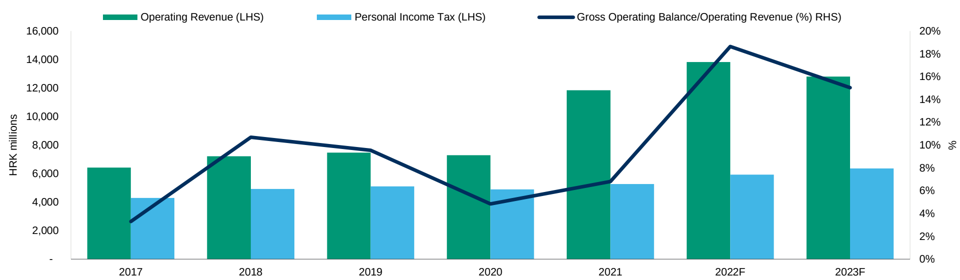
Update following upgrade to Baa2 stable

Summary

The credit profile of the City of Zagreb (Baa2 stable) reflects its consistently prudent budgetary management, solid operating performance, low direct debt levels as well as a strong likelihood that the Government of Croatia (Baa2 stable) will provide support if the city were to face acute liquidity stress. Other factors underpinning the credit profile include Zagreb's large and well diversified local economy contributing to a tax revenue base with low volatility and positive growth trend. Conversely, the rating incorporates the pressure stemming from the city's public services provider, Zagrebacki Holding D.O.O. (Baa2 stable) and the city's transportation company, Zagrebacki Elektricni Tramvaj (ZET)

Exhibit 1

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



Note: from 2021 consolidated accounts; F = Forecast
Source: City of Zagreb, Moody's Investors Service

Credit strengths

» Healthy operating performance fueled by growing tax revenues

» Satisfactory financing results

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

Credit challenges

» Moderate debt levels, but overall manageable

» High indirect exposure to city-owned companies

» Limited liquidity

Rating outlook

The stable outlook on the city mirrors the stable outlook on the sovereign rating. It also reflects the city's stable financial performance and reducing debt burden in the medium term. The city's track record of prudent budgetary management further supports the stable outlook.

Factors that could lead to an upgrade

An upgrade of Zagreb's rating would require a similar change in Croatia's sovereign rating associated with maintaining good financial performance and low debt level.

Factors that could lead to a downgrade

A deterioration of the sovereign credit strength would apply downward pressure on Zagreb's rating given the close financial, institutional and operational linkages between the two tiers of governments. Significant financial deterioration driven by reduced operating margins, an unexpected sharp increase in debt as well as the emergence of liquidity risks, would also exert downward pressure on the city's rating.

Key indicators

Exhibit 2
City of Zagreb

	2017	2018	2019	2020	2021	2022F	2023F
Net Direct and Indirect Debt/Operating Revenue (%)	104.4	70.7	70.8	109.7	65.5	54.1	53.9
Direct Debt/Operating Revenue (%)	23.4	24.0	27.1	33.2	26.7	18.5	13.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	-5.8	-4.1	-7.4	-5.1	-4.7	6.0	4.9
Gross Operating Balance/Operating Revenue (%)	3.3	10.7	9.5	4.8	6.8	18.6	15.0
Debt Service/Total Revenue (%)	6.8	5.3	8.0	9.8	7.6	11.0	8.2
Capital Expenditure/Total Expenditure (%)	10.7	14.9	16.3	11.8	12.9	15.5	12.5
Intergovernmental Transfers/Operating Revenue (%)	5.6	2.5	4.6	7.9	35.5	39.0	34.7

Note: from 2021 consolidated accounts; F = Forecast.
Source: City of Zagreb, Moody's Investors Service

Detailed credit considerations

On 19 July 2022, we upgraded the City of Zagreb's issuer rating to Baa2 stable (from Ba1). This concluded our review for upgrade that was initiated on 28 June 2022.

The credit profile of the City of Zagreb, as expressed in its Baa2 stable rating, combines a Baseline Credit Assessment (BCA) of baa2 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

In 2021, Zagreb's gross operating performance improved to 7% of operating revenues, slightly up from 5% of operating revenues a year earlier. This development reflects economic rebound following the coronavirus pandemic. The shared personal income tax (PIT) and surtax on PIT, both closely dependent on economic development, are the main revenue source for the city. Zagreb's budgetary management has successfully kept the city's operating spending growth in check through a combination of spending reviews and cost controls. 2021's extraordinary real gross domestic product (GDP) growth rate of 10% and 2022's expected GDP growth rate of 3%, combined with above-national average local economy translates into growing proceeds from the income tax, which will support the city's improving GOB to around 18% of operating revenue in 2022. In 2023, we expect the city to post GOB levels in similar double-digit level as 2022 expected (Exhibit 1). The growth in the operating margin will be achieved through a combination of solid growth of tax revenue and continuation of tight control over the operating expenditures.

The 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.

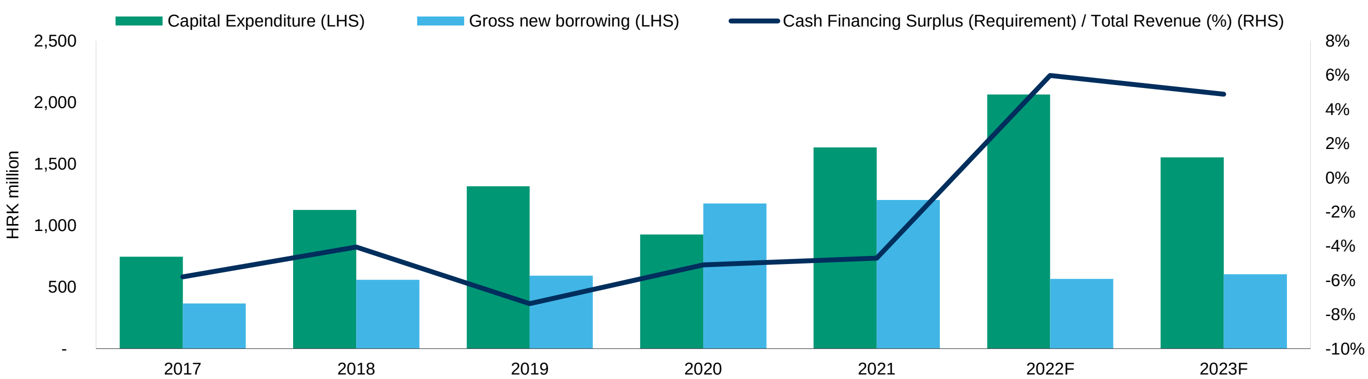
Satisfactory financing results

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 4.7% of total revenue in 2021 compared with 5.1% a year before. From 2022, the city expects to achieve financial surpluses, which we deem realistic (Exhibit 3).

Over the most recent years, the city was able to scale down its capital expenditures, a reaction to lower revenue generation capacity. In 2020 and 2021, capital expenditures were around 12% and 13% of total expenditures, while we saw a level of around 15% of total expenditures in the preceding two years. This indicates high capex flexibility, as some projects can be delayed or abandoned if required. The projections for 2022 capital expenditures indicate a level of around 15% of total expenditures, well achievable in context of expected financial recovery trend.

Exhibit 3

Improving financing results despite high investment needs



Note: from 2021 consolidated accounts; 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 and 2023.

The city will reevaluate its investment priorities following the damages caused by the 2020 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 is significantly reducing 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 more than 180% of the national average, 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.

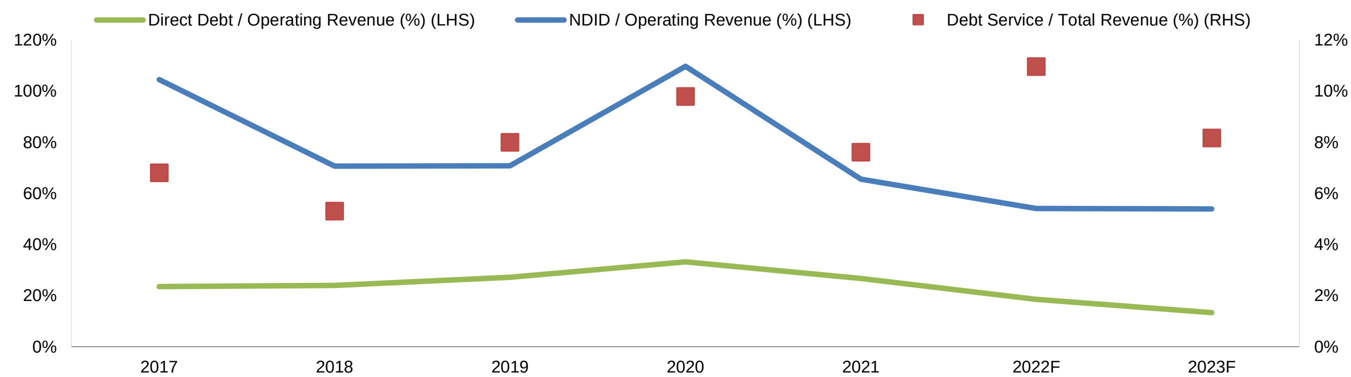
Moderate debt levels, but overall manageable

The city's direct debt increased to HRK3.2 billion, representing still a moderate 27% of operating revenue in 2021. The growth of city's direct debt was primarily driven by funding its infrastructure investments and energy efficiency projects.

We expect the city's direct debt levels to decline over 2022 and 2023, a result of expected financing surpluses allowing for net debt repayment (Exhibit 4). European Union (EU) and the central government grants for infrastructure will help consolidate Zagreb's financial and debt profile.

Exhibit 4

After increase debt levels will gradually decline in 2022



Note: from 2021 consolidated accounts; F = Forecast.
Source: City of Zagreb, Moody's Investors Service

As of 2020, 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 was 8% of total revenue in 2021 from 10% a year before and will remain around that level over 2022-23. We consider these obligations as manageable given the city's strong operating margins.

High indirect exposure to city-owned companies

When accounting for indirect debt, the city's net direct and indirect debt (NDID) was 66% of operating revenue in 2021, expected to decline in line with declining direct debt projections.

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.

The level of guaranteed debt increased to around HRK3.0 billion as of year-end 2021 from HRK2.8 billion in 2020, representing more than 50% of the city's NDID. The increase is due to 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.

In 2022, despite the challenges associated with deterioration of the energy market and continious supply chain disruptions, we expect Holding to post balanced financial results following 1) the organizational restructuring of the Holding company initiated in Q4 2021, 2) amalgamation and optimization of corporate functions, 3) sale of nonoperational property, and 4) agreement with the Trade Union, which should result in additional cost savings.

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 2022 and 2023. The city follows a prudent cash management strategy, which, together with regular distributions of shared taxes, ensures smooth cash flow.

Most recently, we note that liquidity improved over 2021 to a level of around 4% of operating revenues as of year-end 2021. This reflects the fact that the city signed a new HRK400 million interest free loan with the Ministry of Finance in July 2021, which now 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 in the coming years.

Extraordinary support considerations

We consider Zagreb to have a strong 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' financial performance and indebtedness.

ESG considerations

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

Exhibit 5
ESG Credit Impact Score

CIS-2
Neutral-to-Low

For an issuer scored CIS-2 (Neutral-to-Low), its ESG attributes are overall considered as having a neutral-to-low impact on the current rating; i.e., the overall influence of these attributes on the rating is non-material.

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

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-3	S-2	G-2
Moderately Negative	Neutral-to-Low	Neutral-to-Low

Source: Moody's Investors Service

Environmental
Zagreb's overall Environmental 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 Social issuer profile score is assessed as neutral to low (**S-2**). Zagreb benefits from a strong demographic profile. 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, healthcare facilities and provision of basic services are good.

Governance
Zagreb's solid institutions and governance strength is reflected in a neutral to low Governance issuer profile score (**G-2**). This is underpinned by the city's high credibility in managing its operations and development by using prudent financial 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 baa2 is close to the scorecard-indicated BCA of baa3. The matrix-generated BCA of baa3 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 Baa2, as reflected in the sovereign bond rating of Croatia.

Exhibit 7

Zagreb, City of

Regional & 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	178.82%	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%**	**1.28**
Operating Margin [2]	3	6.64%	12.5%			
Interest Burden [3]	1	0.61%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	5	65.54%	25%			
Debt Structure [5]	9	45.65%	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						**2.58 (3)**
Systemic Risk Assessment						**Baa2**
Scorecard-Indicated BCA Outcome						**baa3**
Assigned BCA						**baa2**

[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 2021.

Ratings

Exhibit 8

Category	Moody's Rating
ZAGREB, CITY OF	
Outlook	Stable
Baseline Credit Assessment	baa2
Issuer Rating	Baa2

Source: Moody's Investors Service

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