

Rating Action: Moody's upgrades to Baa2 the ratings of City of Zagreb and Zagrebacki Holding D.O.O.; stable outlooks

19 Jul 2022

Frankfurt am Main, July 19, 2022 -- Moody's Investors Service ("Moody's") has today upgraded to Baa2 from Ba1 the long-term issuer rating of the City of Zagreb (Zagreb) and the long-term issuer ratings of Zagrebacki Holding D.O.O. (Zagrebacki Holding). The outlooks on both are stable. The City of Zagreb's Baseline Credit Assessment (BCA) was also upgraded to baa2 from ba1. This concludes the review for upgrade that was initiated on 28 June 2022.

The rating action follows Moody's decision to upgrade to Baa2 from Ba1 the rating of the Government of Croatia's on 15 July 2022. For full details, please refer to the sovereign press release at: https://www.moodys.com/research/--PR_467651.

RATINGS RATIONALE

RATIONALE FOR RATING UPGRADES

With the sovereign rating upgrade to Baa2 from Ba1 and the improvement of the operating environment following the adoption of the euro, Moody's expects positive repercussions for regional and local governments in the country, including the capital city of Zagreb and its Zagrebacki Holding.

The strengthening long-term growth prospects for the country will have a positive impact on shared taxes and government transfers which represent more than 80% of the City of Zagreb's operating revenue. The capital city's strong economy, which represents one third of the country's GDP, further supports the municipality's revenue base.

The euro adoption will have positive effects on the municipal economy by reducing transaction costs and eliminating any remaining foreign currency risks with important trade partners. Improved economic prospects will likely attract investments, which should contribute to Zagreb's higher tax base in the future.

The Baa2 rating of the City of Zagreb reflects the city's large and well-diversified local economy contributing to a tax revenue base with low volatility and a positive growth trend. Moreover, its traditionally prudent budgetary management resulted in a solid operating surplus of 7% of operating revenue in 2021, expected to further improve in the next couple of years. With financial surpluses expected in 2022, the city's low direct debt will remain below 30% of operating revenue this year. The net direct and indirect debt including the debt of some of its city-owned companies, is moderate at around 66% of its operating revenues in 2022 and will further decline in the medium term thanks to improving financial results and its capital expenditure that will remain largely self-funded.

Moody's has upgraded the city's Baseline Credit Assessment (BCA) to baa2 from ba1. The Baa2 rating for Zagreb also incorporates a strong level of extraordinary support from the Government of Croatia, reflecting our assessment of the city's strategic importance to the national economy.

The upgrade of Zagrebacki Holding's rating to Baa2 from Ba1 reflects the stable institutional and operational framework and strict control over Zagrebacki Holding's operations exercised by the City of Zagreb. Zagrebacki Holding's financial performance has always been influenced by the city's decision on its strategies, business plan, investment programme and borrowing plan. As a result, Moody's believes that Zagrebacki Holding's credit quality ultimately aligns with the City of Zagreb's credit rating.

Zagrebacki Holding's issuer rating takes into account (1) the very strong financial linkages between the Holding and its support provider, the City of Zagreb, as reflected in Zagrebacki Holding's clear public policy mandate and the fact that about two thirds of its financial debt is explicitly guaranteed by the city (2) its key role in managing the city's utilities, and (3) Moody's assessment that the City of Zagreb would provide support should the entity face acute liquidity stress.

RATIONALE FOR THE STABLE OUTLOOKS

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.

The stable outlook on Zagrebacki Holding reflects the stable outlook of its support provider, the City of Zagreb. It also reflects Moody's expectation that Zagrebacki Holding will maintain its strong institutional, operational, economic and financial links with the City of Zagreb.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

ZAGREB

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.

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.

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.

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.

ZAGREBACKI HOLDING D.O.O.

In the case of Zagrebacki Holding D.O.O. Moody's assesses the significance of ESG factors to its credit profile is as follows:

Environmental considerations are not material to Zagrebacki Holding's credit profile.

Social considerations are not material to the Zagrebacki Holding's rating. The Holding is exposed to risks stemming from socially driven policy agendas, and it is also affected by the impact of demographic trends and customer relationships on demand. Nevertheless these risks are not material for the rating, given Zagrebacki Holding's strategic role and the support coming from the City of Zagreb.

Governance risks are material to Zagrebacki Holding's rating. The governance framework is intrinsically intertwined with the supporting government, which exerts strong oversight and ultimately takes key decisions.

The sovereign action on Croatia published on Friday 15 July 2022 required the publication of this credit rating action on a date that deviates from the previously scheduled release date in the sovereign release calendar, published on <https://ratings.moody.com>.

The specific economic indicators, as required by EU regulation, are not available for these entities. The following national economic indicators are relevant to the sovereign rating, which was used as an input to this credit rating action.

Sovereign Issuer: Croatia, Government of

GDP per capita (PPP basis, US\$): [not available] (also known as Per Capita Income)

Real GDP growth (% change): 3% (2022) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 8% (2022)

Gen. Gov. Financial Balance/GDP: -2.8% (2022) (also known as Fiscal Balance)

Current Account Balance/GDP: 5.9% (2022) (also known as External Balance)

External debt/GDP: 69.7% (2022)

Economic resiliency: baa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 14 July 2022, a rating committee was called to discuss the rating of the Zagreb, City of; Zagrebacki Holding D.O.O.. The main points raised during the discussion were: The systemic risk in which the issuer operates has materially decreased.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

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.

The ratings of Zagrebacki Holding could be upgraded if the rating of the city is upgraded.

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.

A downgrade of Zagrebacki Holding's ratings would result from a downgrade of the City of Zagreb's rating or, although not expected, a weakening of the institutional, economic and financial links with the City of Zagreb.

The principal methodology used in rating Zagreb, City of was Regional and Local Governments published in January 2018 and available at <https://ratings.moodys.com/api/rmc-documents/66129>. The principal methodology used in rating Zagrebacki Holding D.O.O. was Government-Related Issuers Methodology published in February 2020 and available at <https://ratings.moodys.com/api/rmc-documents/64864>. Alternatively, please see the Rating Methodologies page on <https://ratings.moodys.com> for a copy of these methodologies.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found on <https://ratings.moodys.com/rating-definitions>.

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Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://ratings.moody.com/documents/PBC_1288235.

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Harald Sperlein
Vice President - Senior Analyst
Sub-Sovereign Group
Moody's Deutschland GmbH
An der Welle 5
Frankfurt am Main, 60322
Germany
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Mauro Crisafulli
MD - Sub-Sovereigns
Sub-Sovereign Group
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

Releasing Office:
Moody's Deutschland GmbH
An der Welle 5
Frankfurt am Main, 60322
Germany
JOURNALISTS: 44 20 7772 5456
Client Service: 44 20 7772 5454

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