Research Update:

Croatia's Capital Zagreb Upgraded To 'BB' On Continued Economic Resilience Supporting Budgetary Results; Outlook Stable

September 23, 2022

Overview

- We expect economic growth in Zagreb to be resilient to higher energy costs, with local tax revenue rising by double-digit percentages.
- We believe that Zagreb will continue to keep a tight grip on operating expenditure, keeping spending growth below inflation rates.
- In addition, we think Zagreb's larger cash reserves and easier access to external liquidity will improve its liquidity situation.
- Contingent liabilities are lower than expected due to the settlement of lawsuits and ongoing low drawings from Zagreb's share of reconstruction costs after the earthquakes.
- Consequently, we raised our rating on Zagreb to 'BB' from 'BB-' and assigned a stable outlook.

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Rating Action

On Sept. 23, 2022, S&P Global Ratings raised its long-term foreign currency issuer credit rating on the Croatian capital city of Zagreb to 'BB' from 'BB-'. The outlook is stable.

Outlook

The outlook is stable because expect Zagreb's budgetary performance will continue to improve, buoyed by high economic growth, despite increasing energy prices. We believe that the ongoing reconstruction of earthquake-devasted areas will be supported by funds from the EU and Croatia's central government.

Downside scenario

We could lower the rating if, contrary to our expectations, the financial pressure on Zagreb and its companies were to rise, for example due to increasing payables alongside declining cash holdings. Fading government support, for example shown via reduced funds for Zagreb to finance major investment projects, could also weigh on the rating.

Upside scenario

We see upward potential for the rating if the city manages to improve its budgetary performance more than we currently expect, for example by implementing stricter cost controls. In addition, further accumulation of cash reserves could reduce Zagreb's dependence on short-term credit. In addition, increased transparency on its financial planning could lead us to consider a positive rating action.

Rationale

The upgrade reflects the city's improved liquidity situation, lower contingent liabilities, and continued economic resilience. We expect tax revenue to rise significantly, fueled by high real GDP growth in 2022 and solid prospects for 2023 and 2024 despite headwinds from geopolitical events. The ratings also take into account Zagreb's moderately high tax-supported debt and a volatile policy environment.

Zagreb continues to receive funds from the EU and Croatia's central government to rebuild infrastructure after earthquakes. The city's share of the cost of rebuilding private properties is significantly lower than we previously expected, thereby reducing our estimate of the city's contingent liabilities compared with our previous projections. We continue to view the city as dependent on having a good relationship with the central government to ensure financing of ongoing projects and infrastructure development.

We expect Zagreb's tax revenue to skyrocket in 2022 and 2023

Higher prices for energy and food will lead to elevated inflation rates in Croatia, further boosting Zagreb's tax revenue. Personal income tax collection is the city's main tax source; the city can theoretically modify the surcharge tax within limits set by central government. We expect a sound rebound of the national economy, with real GDP expanding by 5.8% in 2022, which, coupled with double-digit inflation rates, will lead to Zabreb's tax revenue increasing by more than 17% year-on-year.

Zagreb benefits from its role as Croatia's capital and dominant economic center. The city contributes about one-third of Croatia's GDP. Unemployment is considerably lower than the national average, at 2.8% as of June 30, 2022, versus 6.3%. Zagreb's GDP per capita is comparable with that of similarly rated international peers and significantly higher than the national average. We expect Croatia's real GDP to increase by a still sound 1.75% in 2023 and by 3.5% in 2024, well above other European countries, with Zagreb's GDP per capita developing in line with national growth trends. We anticipate that, in the medium term, Zagreb's economy will benefit from a relatively stable population, which distinguishes the city from the national trend.

We understand that Zagreb's financial management intends to increase the transparency of the city's financials and decisions and implement various savings measures, which should help keep operating expenditure growth below inflation rates. We expect that in 2022-2024 continued investment needs will continue to weigh on Zagreb's budgetary performance.

The rating on the city incorporates our view of the unpredictable institutional framework for Croatian local and regional governments. Changes to tax codes and rates are frequent and complicate financial planning, and the distribution of resources is unbalanced and insufficiently aligned to tasks delegated to municipalities. Zagreb has settled various legal disputes with the Croatian ministry of finance, which we view as a sign of improving cooperation between both administrations despite their opposing partisan backgrounds. Mayor Tomislav Tomasevic, elected in May 2021, has formed a majority coalition in the city council. However, implementing cost-saving measures might be more difficult in future. In some cases, this has been delayed by the courts ruling that such measures should be implemented slower than the city's management intended, so as to give citizens and companies time to adapt.

Zagreb should display sound budgetary performance and improved access to financing through 2024

We expect Zagreb's operating surplus to average about 12% of operating revenue through 2024, thanks to booming tax revenue and cost-cutting measures. Moreover, the city has access to the EU Solidarity Fund until midyear 2023 to alleviate the cost of rebuilding infrastructure after two earthquakes in March 2020. We therefore expect capital expenditure for those projects to decline by then. According to national law, Zagreb needs to cover 20% of the costs of rebuilding the more heavily damaged private buildings. The magnitude of these costs is hard to estimate, but effective drawings on Zagreb's finances were well below budgeted funds until midyear 2022, which we believe is likely to continue, effectively limiting Zagreb's contingent liabilities relating to earthquake-related damage.

Zagreb's budgetary flexibility is limited because most revenue items depend on the central government's decisions. The city cannot change its main revenue source, personal income taxes, except for the surtax charged. However, the surtax 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 of which supply essential public services. Asset sales have been difficult to achieve in recent years and do not provide additional room to maneuver.

We expect Zagreb's tax-supported debt to reach 94% of consolidated operating revenue in 2024, which we regard as high for a local government in Central and Eastern Europe. Direct debt is less than half the city's tax-supported debt, reflecting the substantial use of non-traditional means like factoring and the debt of various municipal companies. We therefore include the debt of Zagrebacki Holding and ZET in our tax-supported debt ratio. We assume Zagreb will accumulate debt beyond its financing needs to help reduce payables to suppliers and further increase its cash holdings according to a new minimum cash holding strategy.

We now view contingent liabilities as lower than previously, since yearly spending on earthquake-related damage remains low. In addition, risks from litigation reduced considerably after the largest case--for more than Croatian kuna (HRK) 10.7 billion (about € 435 million)--was eventually dropped in the first half of 2022, and all outstanding issues with the Croatian ministry of finance have been settled. The remaining contingent liabilities are low in our view, consisting of 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.

In our view, Zagreb's liquidity situation is improving but remains a weakness. Cash on hand increased by midyear 2022, but still covers only about one-half of the next 12 months' debt service and financing needs, leaving the city dependent on raising debt. Furthermore, we now view

Zagreb's access to external liquidity as satisfactory because the city has access to a pool of international banks willing to provide short-term loans if needed.

Key Statistics

Table 1

City of Zagreb--Selected Indicators

	--Fiscal year end Dec. 31--					
Mil. HRK	**2019**	**2020**	**2021**	**2022bc**	**2023bc**	**2024bc**
Operating revenues	7,471	7,154	7,738	8,934	9,431	9,905
Operating expenditures	6,676	6,848	7,117	7,811	8,336	8,741
Operating balance	795	306	621	1,123	1,095	1,164
Operating balance (% of operating revenues)	10.6	4.3	8.0	12.6	11.6	11.8
Capital revenues	158	178	251	331	200	70
Capital expenditures	1,054	787	1,495	1,250	1,270	1,250
Balance after capital accounts	(102)	(304)	(624)	204	25	(16)
Balance after capital accounts (% of total revenues)	(1.3)	(4.1)	(7.8)	2.2	0.3	(0.2)
Debt repaid	671	794	821	1,068	634	688
Gross borrowings	593	1,336	1,396	1,050	700	676
Balance after borrowings	(180)	239	(48)	186	91	(28)
Direct debt (outstanding at year-end)	2,246	2,551	3,096	3,078	3,144	3,131
Direct debt (% of operating revenues)	30.1	35.7	40.0	34.4	33.3	31.6
Tax-supported debt (outstanding at year-end)	8,907	9,911	10,280	10,578	11,144	11,631
Tax-supported debt (% of consolidated operating revenues)	82.2	96.4	102.6	92.8	93.7	94.0
Interest (% of operating revenues)	0.7	0.6	0.6	0.8	0.8	1.0
Local GDP per capita (HRK)	170,831	156,993	173,399	N/A	N/A	N/A
National GDP per capita (HRK)	101,402	93,482	110,741	127,318	136,023	143,313

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. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

City of Zagreb--Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	5

Table 2

City of Zagreb--Ratings Score Snapshot (cont.)

Key rating factors	Scores
Economy	3
Financial management	4
Budgetary perfomance	3
Liquidity	4
Debt burden	3
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

Full Analysis: Croatia, Sept. 19, 2022

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- Institutional Framework Assessments For International Local And Regional Governments, Sept. 13, 2022
- Cyber Risk In A New Era: International Public Finance Is A Target, July 19, 2022
- Updated 2022 Outlook For Local And Regional Governments: Life Without Central Government Crutches, July 13, 2022
- Sovereign Risk Indicators, July 11, 2022
- CEE Cities Are Withstanding Russia-Ukraine War Risks, At Least For Now, May 30, 2022
- Local Government Debt 2022: Rising Risks Keep Global Borrowing High, April 12, 2022
- Public Finance System Overview: Croatian Municipalities, Feb. 7, 2019

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

Upgraded

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