S&P Global
Ratings

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Research Update:

Croatian City of Zagreb Outlook Revised To Positive On Improving Financial Results; 'BB' Ratings Affirmed

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Overview

- Resilient economic growth in Zagreb will support further revenue growth in 2023 and 2024, bolstering solid budgetary performance.
- We believe that the city's management will use budgetary surpluses to reduce payables from previous periods.
- Zagreb's larger cash reserves in 2023 and easier access to external liquidity following Croatia's entry to the eurozone should ease pressure on its tight liquidity situation.
- Consequently, we revised our outlook to positive from stable and affirmed our 'BB' issuer credit rating on Zagreb.

Rating Action

On March 24, 2023, S&P Global Ratings revised its outlook on Croatia's capital of Zagreb to positive from stable. At the same time, we affirmed our 'BB' long-term foreign and local currency credit ratings on Zagreb.

Outlook

The positive outlook reflects our view that strain on Zagreb's financial results might recede as projected economic growth and tight expenditure controls should help mitigate spending pressure from high inflation and large capital expenditure needs.

Upside scenario

We could raise the rating on Zagreb if, over the next 12 months, the city increased predictability on its financial policy while maintaining focus on cost controls, and continues to strengthen its liquidity position by covering a substantial portion of annual debt service.

Downside scenario

We could revise the outlook to stable if financial management fails to continue the envisaged gradual buildup in cash reserves or the city achieves fewer budgetary surpluses, for example due to increased funding needs for its capital expenditure or fewer transfers.

Rationale

The outlook revision reflects Zagreb's improving liquidity situation since the start of 2023 and continued economic resilience with positive GDP growth forecast for 2023-2025. We expect tax revenue to rise significantly despite low economic growth in key Croatian trading partners like Germany. The ratings take into account Zagreb's moderately high tax-supported debt and a volatile policy environment, with potentially rising tensions between government tiers as elections both on the national and municipal levels get closer.

Zagreb will, until mid-2023, continue to receive funds from the EU and Croatia's central government to rebuild public infrastructure after the March 2020 earthquakes, and will continue to receive some cohesion funds thereafter. The city's share of the cost of rebuilding private properties will be spread over a couple of years, which should ease the burden on yearly expenditure. We continue to view Zagreb as dependent on having a good relationship with the central government to ensure financing of ongoing projects and infrastructure development.

Solid economic growth, boosted by eurozone accession, will continue to strengthen the city's revenue base

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 about half the national average of 7.0% at year-end 2022, indicating Zagreb's better socioeconomic profile. We anticipate that, in the medium term, the city's economy will benefit from a relatively stable population, which distinguishes it from the national trend.

Boosted by Croatia's recent accession to the eurozone, we expect the city's economy to grow broadly in line with the national pace. We project sound nominal growth of the national economy in 2023 of more than 8%, down from the high 15% in 2022. Economic growth forecasts outperform most of Croatia's trading partners based on a solid recovery of tourism and less economic dependance on energy prices. The strong economic performance contributes to Zagreb's tax revenue continuing to expand at very sound rates.

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 can theoretically modify the surcharge tax, but has to stay within limits set by the central government. Similarly, fees for municipal services are subject to government approval, further limiting revenue flexibility, as highlighted by the current dispute about water prices.

Mayor Tomislav Tomasevic, elected in May 2021, has formed a majority coalition in the city council. He has implemented a minimum cash policy and reshuffled the city's control over key municipal enterprises, which should limit risks. We believe that implementing cost-saving measures might be more difficult, given consolidation efforts in 2022 like reduction in salaries and employee reduction. In some cases, some measures have been challenged by employees via strikes or delayed by courts that ruled some measures should be implemented slower than management intended.

We understand that Zagreb's financial management intends to increase the transparency of the city's financials and decisions. We expect that continued investment needs will continue to weigh on Zagreb's budgetary performance, and note that funds available from international sources like the EU will decrease, despite the dedicated goal of predominately using these funds for capital expenditure.

Sound budgetary performance should enable the gradual reduction of Zagreb's dependence on short-term loans

We expect Zagreb's operating surplus to average about 12% of operating revenue through 2025, 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. According to national law, Zagreb needs to cover 20% of the costs of rebuilding the more heavily damaged private buildings. The costs are hard to estimate, but effective drawings on Zagreb's finances were well below budgeted funds until 2022, which we believe is likely to continue, effectively limiting the city'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. Expenditure flexibility is constrained by fixed subsidies granted to municipal companies Zagrebacki Holding (ZGH) 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 95% of consolidated operating revenue in 2025, 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 nontraditional means like factoring and the debt of various municipal companies. We therefore include the debt of ZGH and ZET in our tax-supported debt ratio. We assume Zagreb will accumulate debt beyond its financing needs to reduce payables to suppliers and further increase cash holdings in line with a new minimum cash holding strategy.

We regard contingent liabilities as low overall. These consist of spending for earthquake-related damages on private buildings with low yearly drawings, and some litigation risks. In our view, the city might support ZGH and ZET by taking on additional payables from the companies or by injecting capital. Foreign exchange risk is very limited following the adoption of the euro, because all debt is in euros.

In our view, Zagreb's liquidity situation is improving but remains a credit weakness. Cash on hand increased to €37 million by year-end 2022, but still covers less than half of the next 12 months' debt service and financing needs, leaving the city dependent on raising debt. The city reduced parts of payables outstanding in 2022, which we think will ease stress on liquidity. We 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.

Key Statistics

Table 1

City of Zagreb--Selected Indicators

	--Fiscal year ended Dec. 31--					
Mil. €	**2020**	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**
Operating revenue	949	1,019	1,198	1,271	1,225	1,271
Operating expenditure	909	938	1,020	1,123	1,080	1,125
Operating balance	41	81	178	148	145	146
Operating balance (% of operating revenue)	4.3	8.0	14.8	11.6	11.8	11.5
Capital revenue	24	41	8	27	9	9
Capital expenditure	104	205	158	169	166	166
Balance after capital accounts	(40)	(82)	28	6	(12)	(11)
Balance after capital accounts (% of total revenue)	(4.1)	(7.7)	2.3	0.5	(0.9)	(0.8)
Debt repaid	105	110	220	117	69	76
Gross borrowings	177	185	130	111	81	86
Balance after borrowings	32	(6)	(62)	0	0	(0)
Direct debt (outstanding at year-end)	339	411	323	317	329	339
Direct debt (% of operating revenue)	35.7	40.3	27.0	25.0	26.9	26.7
Tax-supported debt (outstanding at year-end)	1,315	1,364	1,318	1,405	1,417	1,494
Tax-supported debt (% of consolidated operating revenue)	96.4	103.3	87.9	89.3	92.8	94.9
Interest (% of operating revenue)	0.6	0.6	0.5	0.7	0.7	0.7
Local GDP per capita (single units)	20,837	22,783	26,180	28,271	29,642	31,200
National GDP per capita (single units)	12,466	14,969	17,178	18,395	19,287	19,957

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	
Institutional framework	5
Economy	3
Financial management	4
Budgetary perfomance	3

Table 2

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

Key rating factors	
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, March 17, 2023

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

- Russia-Ukraine Military Conflict: Key Takeaways From Our Articles, Feb. 23, 2023
- Economic Research: Global Macro Update: Post-Davos, We Reaffirm Our View, Jan. 26, 2023
- Sovereign Risk Indicators, Dec. 12, 2022. Interactive version available at http://www.spratings.com/sri
- Comparative Statistics: Local And Regional Government Risk Indicators: European LRGs Stay Firm Amid Economic Slowdown And High Inflation, Sept. 22, 2022
- Institutional Framework Assessments For International Local And Regional Governments, Sept. 13, 2022

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/Positive/--	BB/Stable/--