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Research Update:

Outlook On Croatian City of Zagreb Revised To Negative Following Similar Action On The Sovereign; 'BB' Rating Affirmed

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Overview

- On July 17, 2015, we revised our outlook on Croatia to negative from stable and affirmed the 'BB/B' sovereign credit ratings.
- Under our methodology for rating local and regional governments, we currently do not rate the City of Zagreb higher than Croatia.
- Consequently, we are revising our outlook on Zagreb to negative from stable and affirming our 'BB' rating on the city.
- The negative outlook reflects that on Croatia.

Rating Action

On July 20, 2015, Standard & Poor's Ratings Services revised its outlook on the Croatian City of Zagreb to negative from stable and affirmed its 'BB' long-term issuer credit rating.

As defined in EU CRA Regulation 1060/2009 (EU CRA Regulation), the ratings on Zagreb are subject to certain publication restrictions set out in Article 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Calendar Of 2015 EMEA Sovereign, Regional, And Local Government Rating Publication Dates: Second-Quarter Update," published July 10, 2015, on RatingsDirect). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In the case of Zagreb, the deviation has been caused by the outlook revision to negative from stable on the long-term rating on Croatia on July 17, 2015.

Rationale

The outlook revision follows a similar action on Croatia on July 17, 2015 (see "Croatia Outlook Revised To Negative On Lackluster Reform Efforts; 'BB/B' Ratings Affirmed").

In accordance with our criteria for rating non-U.S. local and regional governments (LRGs) and their related sovereigns, we generally cap the long-term rating on an LRG at the same level as its respective sovereign. We do not believe that the institutional and financial framework for Croatian LRGs allows any of them to be rated above the sovereign. In particular, we view Croatian LRGs' autonomy as limited by their revenues' dependence on transfers or shared taxes from the sovereign. In addition, Croatian LRGs' revenue-expenditure balance has been undermined several times over the past few years by the central government's changes to the tax system,

most recently the realignment of income tax brackets. As a result, we consider that the long-term rating on Zagreb cannot be higher than that on the sovereign, leading us to revise our outlook on the rating to negative in line with that on Croatia.

The rating on Zagreb reflects our view of the city's weak budgetary flexibility, financial management, and liquidity position, as our criteria define these terms. It also reflects our view of the volatile and unbalanced institutional framework for Croatian cities and Zagreb's average economy. These factors are somewhat offset by the city's very strong budgetary performance, low debt, and moderate contingent liabilities.

The long-term rating on Zagreb is equivalent to our assessment of its stand-alone credit profile, which we assess at 'bb'. In our base case, we believe that tight control over operating spending should allow Zagreb to maintain strong budgetary performance and gradually reduce its debt burden amid economic stagnation in Croatia.

Liquidity

We view Zagreb's liquidity position as weak, owing to the city's limited access to external liquidity. We also believe that the dwindling operating surplus indicates that the city's internal cash-generating capacity has weakened somewhat.

Outlook

The negative outlook on Zagreb reflects that on Croatia.

If we lowered the long-term rating on Croatia, we would lower the long-term rating on Zagreb because we consider that Croatian cities cannot be rated above the sovereign, according to our criteria.

Moreover, we might consider a negative rating action on Zagreb, if we see weakening budgetary performance and debt increases that exceed our forecast. We could also lower the ratings if we saw the city's liquidity position deteriorate further due to dwindling cash reserves, or if we changed our assessment of the city's financial management due to uncertainties regarding the political leadership.

We could revise the outlook on Zagreb to stable if we revised the outlook on the long-term sovereign credit rating on Croatia to stable and, at the same time, Zagreb continued to perform in line with our base-case scenario.

Key Statistics

Please see "Croatian Capital City of Zagreb Affirmed At 'BB' On Ongoing Very Strong Budgetary Performance; Outlook Stable," published Feb. 13, 2015

Ratings Score Snapshot

Please see "Croatian Capital City of Zagreb Affirmed At 'BB' On Ongoing Very Strong Budgetary Performance; Outlook Stable," published Feb. 13, 2015

Key Sovereign Statistics

Croatia Outlook Revised To Negative On Lackluster Reform Efforts; 'BB/B' Ratings Affirmed, July 17, 2015

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign - December 15, 2014
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013

Related Research

- Sovereign Risk Indicators, June 30, 2015. For an interactive version visit www.spratings.com/sri.

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

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Ratings

	To	From
Zagreb (City of)		
Issuer credit rating		
Foreign and Local Currency	BB/Negative/--	BB/Stable/--

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