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Research Update:

Croatian Capital City of Zagreb Affirmed At 'BB' On Lower Debt Burden; Outlook Negative

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Overview

- Despite a weakening of the Croatian capital city Zagreb's revenue-raising capacity due to the changes to the personal income tax, the city continues to demonstrate very strong budgetary performance in line with our base-case scenario.
- We are therefore affirming our 'BB' ratings on Zagreb.
- The negative outlook reflects that on Croatia.

Rating Action

On Aug. 14, 2015, Standard & Poor's Ratings Services affirmed its 'BB' long-term issuer credit rating on Croatia's capital, the City of Zagreb. The outlook is negative.

Rationale

The rating on Zagreb reflects the city's weak budgetary flexibility, financial management, and liquidity position. Supportive factors are our assessment of Zagreb's average economy, very strong budgetary performance, low debt, and moderate contingent liabilities, as our criteria define these terms. We assess Zagreb's stand-alone credit profile (SACP) at 'bb'.

The affirmation reflects our view that Zagreb will continue to perform in line with our base case through to year-end 2017, owing to tight control over spending. This is although we have reassessed the institutional framework as volatile and unbalanced, compared with evolving but unbalanced previously. Over the past few years, the central government has taken several measures to alleviate the tax burden on the population. One effect of this is the continuous shrinking of local governments' revenue-raising capacity and the weakening of their revenue-expenditure balances. Consequently, we regard the institutional framework under which Croatian local and regional governments (LRGs) operate as having deteriorated.

We consider that Zagreb's financials lack long-term planning in what we view as the volatile and unbalanced institutional framework. The central government's changes to the personal income tax system, the city's main revenue source, at the beginning of the year have reportedly reduced Zagreb's revenues by about 12%, based on last year's revenues. We believe this would dent the city's financials but that its operating budgetary performance would remain strong. In addition, the central government's strained financial position limits its capacity to provide extraordinary support to LRGs, in our opinion.

This situation is exacerbated by the city's weak financial management and volatile political situation. Although the city's mayor, Milan Bandic, is back in office,

court proceedings against him are still ongoing and his political future, including his political ambitions, remain somewhat unclear. Despite this, the city continued to function during Mayor Bandic's absence and the 2015 budget and revision of the 2014 budget were passed in a timely fashion under then-deputy mayor Sandra Švaljek, which speaks to the city's improved administrative capacity.

Our assessment of Zagreb's financial management reflects our view of the city's generally limited political and managerial strength, with a history of very strained relations between the government and the council, short-term financial planning, broad use of unconventional debt instruments, and relatively loose control over government-related entities. After the city's government reestablished control over Zagrebacki Holding in 2014, it took measures to strengthen both its and the company's liquidity position and financial performance. We understand the city plans to gradually reduce its financial involvement in Zagrebacki Holding, partly owing to the city's budgetary limitations.

We view Zagreb's economy as average. Although Croatia's GDP per capita is relatively low, at around US\$12,000 on average in 2015-2017, Zagreb boasts a broad and diversified economy thanks to its dominant economic, financial, and political role in the country. It is home to 19% of the country's population and produces about 33% of the national GDP.

In our base-case scenario, we project that the city's budgetary performance will remain very robust. Because national legislation imposes strict limits on gross municipal borrowings, the city cannot afford to continue posting a deficit after capital accounts. Moreover, in 2013-2014 the city provided financial support to Zagrebacki Holding via factoring contracts, which we now view as Zagreb's direct debt. Although this increased Zagreb's debt, it has also improved its surplus after capital accounts in our forecasts because we reclassify spending on contracts as debt service. Consequently, in our base-case scenario for 2015-2017, we expect Zagreb to maintain a moderate surplus after capital accounts of about 2.9% of revenues, slightly lower than the 3.6% average surplus in 2012-2014.

However, despite tight control over operating spending, we expect the city's operating surplus to be about 13.6% of operating revenues on average over 2015-2017 following the central government's reform of the personal income tax regime. This is similar to the average over 2012-2014.

We also consider that the city's commitment to providing ongoing support to Zagrebacki Holding constrains its budgetary flexibility and increases its contingent liabilities. The transfers are to service debt at Zagrebacki Holding, which is linked to Zagreb's outsourcing of its investment program and the associated debt accumulation by Zagrebacki Holding. We understand the outsourcing of investments will stop, however.

In our base-case scenario, we assume that the city's tax-supported debt will remain low. Including Zagrebacki Holding's debt, it will likely decrease to about 53% of consolidated operating revenues by year-end 2017 from 85% at year-end 2013. Zagreb

reported direct debt at a fairly modest 36% of operating revenues for 2014, owing to financial support to the holding company. The city's direct debt includes guarantees that it currently services and a recently acquired debt secured by its commitment to Zagrebacki Holding. We also assume that Zagreb will continue to generate strong operating surpluses that will mitigate its debt burden.

We view Zagreb's budgetary flexibility as weak, mainly because the city cannot influence the personal income tax rate, its main source of revenue. In addition, the central government has limited Zagreb's ability to raise the surcharge on this tax beyond its current level of 18%. The city is finding it difficult to cut expenditures further because about two-thirds of its operating spending is extremely inflexible and almost 50% of capital expenditures have already been allocated. However, it has implemented some measures to offset the revenue shortfall, for instance, it cut subsidies to Zagrebacki Holding and further reduced its headcount. In addition, the city plans to compensate for the expected shortfall in personal income tax revenue by selling some of its assets, particularly real estate, although these sales may not materialize because of the depressed state of the economy. Even if these sales materialize, it would have only a one-time benefit for the budget.

We view the city's contingent liabilities as moderate. After a favorable court decision concerning outstanding payables and the partial payment of overdue payables to suppliers, the city's payables reduced to a moderate 10% of revenues in 2014. Taking into account that Zagrebacki Holding has also managed to reduce its overdue payables, we now estimate the potential cost to recapitalize the budget at about 10%-12% of consolidated operating revenues.

Liquidity

We view Zagreb's liquidity position as weak, owing to the city's less-than-adequate debt service coverage and 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.

We forecast the city's average cash position, including the projected surplus after capital accounts, will reach about Croatian kuna (HRK) 350 million (about US\$50 million) over the next 12 months. This will likely cover about 50% of the city's debt service falling due within this period. We estimate the city's annual debt service in 2015 at about HRK620 million, including payments for factoring agreements made on behalf of Zagrebacki Holding. The city's debt repayment schedule is smooth and doesn't contain any large one-time payments. In line with our base-case scenario for 2015 and 2016, we project Zagreb's operating surplus before interest to be lower than 2x its annual debt service in 2015-2016.

That said, the city had substantially decreased its payables to a moderate 10% of its annual budget by the end of 2014, thereby alleviating pressure on its liquidity position. During the toughest stage of economic contraction, payables accumulated quickly and peaked at about 23.7% of annual expenditures at year-end 2011.

We view Croatia's banking system as exposed to ongoing economic contraction. This is reflected in our placement of the country's system in group '8' according to our Banking Industry Country Risk Assessment, on a scale of '1' to '10' with group '1' indicating the lowest risk (see "Banking Industry Country Risk Assessment: Croatia," published Nov. 26, 2014, on RatingsDirect). Because the city continues to accumulate debt, thereby increasing its exposure to market sentiment, we now view its access to external liquidity as limited. We consider our inclusion of the factoring deals the city concluded on behalf of Zagrebacki Holding in our calculation of direct debt and liquidity as a mitigating factor.

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, which could also lead to a weaker assessment of the city's debt if operating surpluses were lower-than-expected in our forecast. We could also lower the rating 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 because of 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

Table 1

City of Zagreb Financial Statistics						
	--Fiscal year ending Dec. 31--					
(Mil. HRK)	2012	2013	2014	2015bc	2016bc	2017bc
Operating revenues	6,378	6,604	6,607	6,297	6,482	6,754
Operating expenditures	5,543	5,560	5,808	5,504	5,609	5,769
Operating balance	835	1,044	799	794	874	985
Operating balance (% of operating revenues)	13.1	15.8	12.1	12.6	13.5	14.6
Capital revenues	82	229	66	200	100	100
Capital expenditures	882	992	790	820	820	820
Balance after capital accounts	35	281	75	173	153	264
Balance after capital accounts (% of total revenues)	0.5	4.1	1.1	2.7	2.3	3.9
Debt repaid	293	272	308	380	399	369
Balance after debt repayment and onlending	(264)	11	(229)	(207)	(246)	(104)
Balance after debt repayment and onlending (% of total revenues)	(4.1)	0.2	(3.4)	(3.2)	(3.7)	(1.5)
Gross borrowings	150	150	190	220	220	220

Table 1

City of Zagreb Financial Statistics (cont.)						
(Mil. HRK)	--Fiscal year ending Dec. 31--					
	2012	2013	2014	2015bc	2016bc	2017bc
Balance after borrowings	(114)	161	(39)	14	(26)	116
Operating revenue growth (%)	(0.1)	3.5	0.0	(4.7)	2.9	4.2
Operating expenditure growth (%)	1.7	0.3	4.5	(5.2)	1.9	2.9
Modifiable revenues (% of operating revenues)	36.5	36.9	35.1	36.7	36.5	36.2
Capital expenditures (% of total expenditures)	13.7	15.1	12.0	13.0	12.8	12.4
Direct debt (outstanding at year-end)	1,023	2,801	2,411	2,411	2,411	2,411
Direct debt (% of operating revenues)	16.0	42.4	36.5	38.3	37.2	35.7
Tax-supported debt (% of consolidated operating revenues)	69.3	85.0	66.2	67.3	61.5	53.3
Interest (% of operating revenues)	1.0	0.8	1.9	1.9	1.8	1.8
Debt service (% of operating revenues)	5.6	4.9	6.6	8.0	8.0	7.2

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's 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 Standard & Poor's expectations of the most likely scenario. HRK--Croatian kuna.

Table 2

City of Zagreb Economic Statistics						
	--Fiscal year ending Dec. 31--					
	2012	2013	2014	2015bc	2016bc	2017bc
Population	793,057	793,929	795,505	794,705	795,500	795,500
Population growth (%)	0.4	0.1	0.2	(0.1)	0.1	0.0
GDP per capita (HRK)	140,814	142,223	140,361	145,624	152,541	159,787
Unemployment rate (%)	9.5	9.5	9.5	9.5	9.5	9.5

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, Eurostat, and Experian Ltd. bc--Base case: reflects Standard & Poor's expectations of the most likely scenario. HRK--Croatian kuna.

Ratings Score Snapshot

Table 3

City of Zagreb Ratings Score Snapshot

Key rating factors	
Institutional framework	Volatile and unbalanced
Economy	Average
Financial management	Weak
Budgetary flexibility	Weak
Budgetary performance	Very strong
Liquidity	Weak
Debt burden	Low
Contingent Liabilities	Moderate

*Standard & Poor's ratings on local and regional governments (LRGs) are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments" summarizes how the eight factors are combined to derive the foreign currency rating on an LRG.

Key Sovereign Statistics

Research Update: 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. An interactive version is available at <http://www.spratings.com/SRI>
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Public Finance System Overview: Croatian Municipalities, May 7, 2015
- Banking Industry Country Risk Assessment: Croatia, Nov. 26, 2014

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.

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

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