MOODY'S
INVESTORS SERVICE

Credit Opinion: Zagreb, City of

Global Credit Research - 16 Mar 2016

Croatia

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Ba2

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Key Indicators

Zagreb, City of

	2011	2012	2013	2014	2015
Net Direct and Indirect Debt/Operating Revenue (%)	112.9	111.6	96.9	108.4	112.2
Total Direct Debt/Operating Revenue (%)	8.4	8.4	7.3	22.0	23.1
Cash Financing Surplus (Requirement)/Total Revenue (%)	-2.1	-0.5	9.2	-14.8	1.8
Gross Operating Balance/Operating Revenue (%)	13.8	14.4	22.1	12.5	9.5
Debt Service/Total Revenue (%)	3.4	3.1	2.6	4.6	4.9
Self-financing Ratio	0.9	1.0	1.0	0.5	1.0
Intergovernmental Transfers/Operating Revenue (%)	1.0	0.7	0.8	1.7	2.4

Opinion

SUMMARY RATING RATIONALE

The City of Zagreb's Ba2 issuer rating reflects its good operating surpluses, albeit challenged by weak growth performance of national economy and recent changes in income tax law; the city's manageable direct debt burden and its overall good fiscal discipline. The rating also takes into account Zagreb's crucial role in the national economy as the capital city of Croatia.

Conversely, the rating also reflects the challenges associated with the city's significant indirect debt exposure through its majority-owned company, Zagrebacki Holding (Ba3 negative), improved but still low liquidity and limited revenue control under current framework. Factored into the rating considerations is also the country's impaired medium-term economic growth outlook, which affects the city's tax base and tax proceeds.

On 14 March 2016 Moody's downgraded the issuer rating of the City of Zagreb to Ba2 from Ba1 following the downgrade of the Government bond rating of Croatia to Ba2 from Ba1.

Credit Strengths

- Still good operating margins albeit challenged by weak growth performance of national economy and recent changes in income tax law.

- Improvement in financial performance thanks to contained capex plans.

- Increased direct debt remains at manageable levels.

- A crucial role in the national economy.

Credit Challenges

- Pressure stemming from city's owned Zagrebacki Holding, although its effective restructuring program is continuing.

- Improved but still low liquidity.

- Limited revenue control under current framework.

Rating Outlook

The negative outlook on the city reflects the outlook on Croatia's sovereign rating.

What Could Change the Rating - Up

Stabilisation of the outlook or an upgrade of Zagreb's rating would result from (1) a similar action on Croatia's sovereign rating, given their close financial and operational linkages; and (2) substantial and sustained improvement of the city's operating surpluses and a reduction of its net direct and indirect debt.

What Could Change the Rating - Down

A downgrade of Zagreb's rating would result from (1) a downgrade of Croatia's sovereign rating; (2) a material deterioration in the city's operating performance; and/or (3) a further increase in its debt and debt-servicing needs.

DETAILED RATING CONSIDERATIONS

Zagreb's rating combines (1) the baseline credit assessment (BCA) for the City of Zagreb; and (2) a moderate likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

STILL GOOD OPERATING MARGINS ALBEIT CHALLENGED BY WEAK GROWTH PERFORMANCE OF NATIONAL ECONOMY AND RECENT CHANGES IN INCOME TAX LAW

Zagreb's operating performance has not been immune to Croatia's long economic recession. The city's gross operating balance (GOB) dropped to 13% of operating revenues in 2014 from the average of 17% in 2009-2013. In 2015, further fall in contributions from the income tax, which largely reflected changes in the Law on Income Tax from November 2014, caused the GOB to decline below 10% of operating revenue for the first time over the last ten years.

The city's austerity measures applied throughout 2014 and particularly in 2015, which stopped growth in operating expenditure, were not sufficient to mitigate the two-year consecutive 10% decline in contributions from the income tax. Such a decline poses a credit risk to Zagreb because contributions from this tax are the city's key revenue source. In 2015, Zagreb derived 70% of its operating revenues from the proceeds of income taxes. The city's second largest source of income is own-source revenue, including local taxes, fees and charges, accounting for 26% of its operating revenue at year-end 2015.

Nevertheless, Moody's believes that Zagreb will manage to stabilize its operating margins at level of around 12% of operating revenue planned for 2016-17 despite the increasing rigidity in operating expenditure and sluggish national economy growth forecasts.

Zagreb's sound governance and management practices, as well as clearly defined internal policies and procedures, have supported the city's operations. The City of Zagreb consistently provides comprehensive financial documents in compliance with legislative requirements.

IMPROVEMENT IN FINANCIAL PERFORMANCE THANKS TO RETURN TO CONTAINED CAPEX PLAN

Zagreb's funding performance is strictly tied to its capital spending. Deterioration of the city's operating balance happened at a time of a highest level in capital expenditure over the past five years amounting HRK1.85 billion in 2014, compared with HRK1.05 billion on average during 2010-13. This has led to a financial deficit of 15% of total revenue.

On a contrary, downward adjustments in capital spending, which was reduced by half compared to the initial plans, enabled the city to return to financial surplus of almost 2% of total revenue in 2015.

Official projections for 2016-17 indicate contained annual capex below HRK1.0 billion, which should keep the city's financial performance in positive territory with only limited recourse to new debt. Moody's believes that Zagreb's administration will continue to be able to match capex with available funding opportunities.

INCREASED DIRECT DEBT REMAINS AT MANAGEABLE LEVELS

With the acceleration of its capital expenditure, the city's stock of direct debt grew to HRK1.46 billion in 2014 from HRK0.5 billion at year-end 2013. While rapidly growing, the city's direct debt remained manageable, as it represented still low 22% of operating revenue in 2014 compared with 7% at year-end 2013. In 2015 the direct debt remained at HRK1.42 billion representing 23.1% of operating revenue. The notable growth in debt was driven by the completion of a sale of Zagrebacki Holding's non-operating properties Gredelj and Zagrepcanka, with the city assuming the properties from the Holding to support its financial restructuring. Zagrebacki Holding used the proceeds from the property sale amounting HRK961 million to service its overdue commercial payables and reduce its debt burden.

Although we regard this debt increase as a credit constraint in light of weakened operating margins, we note that the city will benefit from long term maturities (10 years), which makes the debt and related debt service still well manageable.

The debt service increased close to 5% of total revenue in 2014 and 2015 from previous years' average of 3% following the increase in the city's debt burden and is expected to stabilize at this level in the medium term. Entire direct debt of Zagreb was comprised of bank loans at year-end 2015 and denominated in local currency.

In 2016-17, we expect the city's direct debt to steady close to 20% given the limitations on local government borrowing imposed by the central government and the city's commitment to focus mostly on EU-funded projects from the new financial framework 2014-20.

A CRUCIAL ROLE IN THE NATIONAL ECONOMY

The City of Zagreb is the capital of Croatia and the country's largest city, with 19% of the national population (last census of 2011). As the nation's capital, Zagreb contributes significantly to the national economy, accounting for one third of national GDP. With local GDP at 180% of the national average (2012 latest available data), Zagreb ranks the highest among Croatian cities. The city is the base for almost 34% of Croatia's businesses, which provide 36% of the country's exports and 29% of total employment (2013 latest available data).

Commerce and industry represent the major drivers of Zagreb's economy, contributing around 42% to local output and absorbing 18% and 11% of the workforce respectively. A diversified industrial basis benefits Zagreb. The city has a strong presence of food processing, machinery construction, petrochemical and chemical industry and light industries. Zagreb is the seat of the central government and hosts the country's main universities and headquarters of the largest companies.

PRESSURE STEMMING FROM ZAGREBACKI HOLDING REMAINS, ALBEIT EFFECTIVE RESTRUCTURING PROGRAM IS CONTINUING

The major businesses operated by the city's 100%-owned company Zagrebacki Holding are extremely important for the city and require its ongoing support, either in the form of subsidies or a regulatory framework. Operating and capital transfers to its Holding, are among the main drivers of Zagreb's spending policy (12% of total expenditures in 2015). In addition the City of Zagreb subsidises part of Zagrebacki Holding's debt repayment costs, which is directly serviced by the city, amounting HRK136 million equivalent of 2% of operating revenue in 2015. Moody's considers these obligations as manageable given the city's still good operating margins.

Although the indirect debt exposure, entirely represented by either city-guaranteed or unsecured debt of the holding company, substantially declined to around HRK5.5 billion in 2015 (preliminary estimate) from HRK6.4 billion at year-end 2013, it still represents a sizeable burden for the city. When accounting for indirect debt, the city's direct and indirect debt has reached 112% of operating revenue in 2015 compared with 97% in 2013. In 2016-17, Zagreb's direct and indirect exposure is expected to decline below 100% of operating revenue.

The ongoing restructuring program initiated in the second half of 2013 has thus far resulted in the improved financial position of the holding. Holding's operating performance continued to improve in 2014 with EBITDA margin of 18% (17.5% in 2013) compared with 11% in 2012. According to the Holding's unaudited statements for 2014 the company posted net income of 1% of its operating income for second consecutive year, a good progression, which is expected to continue in 2015, compared with -6% posted in 2012 and 2011. Its EBIT-to-operating-revenue ratio also remained stable at around 5% (6.5% in 2013 and 0.1% in 2012).

A renewed fiscal discipline and increased control over the holding speak in favour of Zagreb's ability to contain financial risks off-balance sheet and limit borrowing requirements going forward.

IMPROVED BUT STILL LOW LIQUIDITY

The city's average cash position further improved averaging HRK172 million in 2015 from HRK98 million in 2013, still representing a low 2.8% of operating revenue. Notwithstanding the increase in cash reserves, indicating certain improvement of city's liquidity in the last three years, we expect that Zagreb's cash position will remain at low single-digit levels due to persistently challenging macroeconomic condition and a weakening revenue base. However, the city's regular and predictable inflows and outflows throughout the year and cash-generating capacity should offset this low liquidity. Zagreb does not maintain emergency lines of credit.

LIMITED REVENUE CONTROL UNDER CURRENT FRAMEWORK

The institutional framework features low financial predictability and stability. Zagreb has very limited control over its revenue base, which consists mainly of shared taxes (personal income tax). In fact, local tax revenues represent a minor proportion of municipal revenue. This high fiscal dependence on state resources exposes municipal finances to the performance of the general government budget and evolving intergovernmental relations.

Partially mitigating this lack of discretionary powers on the revenue side, the framework allows the City of Zagreb to raise some additional funds through a PIT surtax, over which it has full discretion. However, we understand that the city's current PIT surtax is the highest in the country, making any increase politically sensitive. Furthermore, both the active role played by city-owned holding company in containing expenditure pressure and the flexibility offered by the large proportion of capital expenditure within the municipal budget offer additional cushion to balance the budget.

We do not expect that the composition of Zagreb's operating revenue will significantly differ in 2016-17, given that local finances in Croatia depend on the decisions of the central government, leaving the local governments with only limited leeway with regard to taxes and fees.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government, reflects Moody's assessment of the central government's promotion of greater accountability for cities, coupled with relatively strong oversight over local government finances.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Zagreb, the BCA matrix generates an estimated BCA of ba2 which is in line with the BCA assigned by the rating committee. The matrix-generated BCA of ba2 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Ba2, as reflected in the sovereign rating (Ba2 negative).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Zagreb, City of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	180.00	70%	1	20%	0.20
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	4	20%	0.80
Financial flexibility	3		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	1	15.51	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	3	1.04	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	108.40	25%			
Short-term direct debt / total direct debt	3	11.10	25%			

(%)						
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.28(2)
Systemic Risk Assessment						Ba2
Suggested BCA						ba2

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