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Research Update:

Croatian Capital City of Zagreb Affirmed At 'BB'; Outlook Negative

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Overview

- Zagreb has demonstrated its ability to withstand challenges to its revenue-raising capacity following changes to Croatia's personal income tax regime last year. 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 July 22, 2016, S&P Global Ratings affirmed its 'BB' long-term issuer credit rating on Croatia's capital, the City of Zagreb. The outlook remains negative.

Rationale

The rating on Zagreb reflects the city's weak budgetary flexibility, financial management, and liquidity position and the volatile and unbalanced institutional framework for Croatian local and regional governments (LRGs). Supportive factors are our assessment of Zagreb's average economy, very strong budgetary performance, low debt, and moderate contingent liabilities. 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 2018, owing to demonstrated tight control over spending. At the same time, we assess the institutional framework under which Zagreb operates as volatile and unbalanced as 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 balance, exemplified by the 2015 changes to the personal income tax regime which reduced Zagreb's operating revenues by about 7%, compared to 2014.

We consider that Zagreb lacks long-term planning as a result of the institutional framework under which it operates. The central government changed the personal income tax system, the city's main revenue source, at the beginning of 2015. The negative impact of this was mitigated by growth in employment after six years of recession, rendering the actual 2015 results better than we had previously forecast. We expect this growth momentum in Croatia to continue over the forecast horizon, and as a result we expect the city’s budgetary performance to remain very strong. The central government's strained financial position, however, limits its capacity to provide extraordinary support to Zagreb or other Croatian LRGs, in our opinion.

This situation is exacerbated by Zagreb's weak financial management and volatile political situation. A party under the chairmanship of the city's mayor, Milan Bandic, participated in last year's parliamentary election at the national level and will likely also participate in the early elections in September this year. Therefore, we cannot rule out that the mayor may leave for a different political office following the parliamentary election, although we do not view this scenario as likely.

Our assessment of Zagreb's financial management reflects 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 direct financial involvement in its main government-related entity Zagrebacki Holding (ZGH), partly owing to the city's budgetary limitations. However, the city continues to actively support ZGH and a city-issued guarantee was provided in the holding's eurobond refinancing process.

We view Zagreb's economy as average. Although Croatia's GDP per capita is relatively low, at around US$12,000 on average in 2016-2018, Zagreb boasts a broad and diversified economy thanks to its dominant economic, financial, and political role in the country. Adding to the diversification of Zagreb's economy is the increasing numbers of tourist arrivals to the city. It is home to 19% of the country's population and produces about 33% of the national GDP leading to per capita income, which is significantly higher than the national average.

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 2016-2018, we expect Zagreb to maintain a moderate surplus after capital accounts of about 3% of revenues, slightly higher than the 2.4% average surplus in 2013-2015.

At the same time, despite tight control over operating spending, we expect the city's operating surplus to be about 11.5% of operating revenues on average over 2016-2018 following the central government's reform of the personal income tax regime. This is lower than the 13.7% average over 2012-2014. This reduction is mostly due to the central government's reform of the personal income tax regime, which halved the local government's personal income tax absorption rate.

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. Moreover, the city's major public transit company ZET may be transferred back into the city's portfolio.

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 69% of consolidated operating revenues by year-end 2018 from 83% at year-end 2015. Zagreb's reported direct debt is even lower at a fairly modest 45% of operating revenues for 2015. The city's direct debt includes guarantees that it currently services and two factoring deals it services on behalf of Zagrebacki Holding. We also assume that Zagreb will continue to generate strong operating surpluses that will mitigate its debt burden in line with Croatia's economic recovery, after six years of recession. The city’s budgetary performance, even in this adverse environment, has been quite solid.

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 expenditure has already been allocated. However, it has implemented some measures to offset the revenue shortfall. For instance, it cut subsidies to Zagrebacki Holding and the holding further reduced staff levels. In addition, the city plans to keep compensating for potential revenue shortfalls by selling some of its assets, particularly real estate. Even if these sales materialize, however, they 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 and has been reduced considerably since then. Noting 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 somewhat weakened.

We forecast the city's average cash position, including the projected surplus after capital accounts, will reach about Croatian kuna (HRK) 250 million (about US$40 million) over the next 12 months. This will likely cover slightly over 40% of the city's debt service falling due within this period. We estimate the city's annual debt service in 2016 at about HRK600 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 2016, we project Zagreb's operating surplus before interest to be lower than 2x its annual debt service in 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 Oct. 22, 2015, on RatingsDirect). Because the city continues to accumulate debt, thereby increasing its exposure to market sentiment, we 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 the city's liquidity position deteriorated due to dwindling cash reserves, or if we changed our assessment of the city's financial management because of uncertainties regarding 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 end Dec. 31--					
(Mil. HRK)	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**
Operating revenues	6,604	6,607	6,167	6,535	6,605	6,697
Operating expenditures	5,560	5,808	5,519	5,796	5,861	5,901
Operating balance	1,044	799	648	739	744	797
Operating balance (% of operating revenues)	15.8	12.1	10.5	11.3	11.3	11.9
Capital revenues	229	66	46	32	100	100

Table 1

City of Zagreb Financial Statistics (cont.)

	--Fiscal year end Dec. 31--					
(Mil. HRK)	**2013**	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**
Capital expenditures	992	790	567	583	650	650
Balance after capital accounts	281	75	127	188	194	247
Balance after capital accounts (% of total revenues)	4.1	1.1	2.0	2.9	2.9	3.6
Debt repaid	272	308	522	430	440	410
Net budget loans	2	5	1	N/A	N/A	N/A
Balance after debt repayment and onlending	11	(229)	(394)	(242)	(246)	(163)
Balance after debt repayment and onlending (% of total revenues)	0.2	(3.4)	(6.3)	(3.7)	(3.7)	(2.4)
Gross borrowings	150	190	193	200	200	200
Balance after borrowings	161	(39)	(202)	(42)	(46)	37
Operating revenue growth (%)	3.5	0.0	(6.7)	6.0	1.1	1.4
Operating expenditure growth (%)	0.3	4.5	(5.0)	5.0	1.1	0.7
Modifiable revenues (% of operating revenues)	36.9	35.1	36.2	35.7	35.6	35.3
Capital expenditures (% of total expenditures)	15.1	12.0	9.3	9.1	10.0	9.9
Direct debt (outstanding at year-end)	2,801	2,445	2,798	2,568	2,328	2,118
Direct debt (% of operating revenues)	42.4	37.0	45.4	39.3	35.3	31.6
Tax-supported debt (% of consolidated operating revenues)	85.0	66.4	83.3	75.2	70.3	69.1
Interest (% of operating revenues)	0.8	1.9	1.9	1.7	1.7	1.7
Debt service (% of operating revenues)	4.9	6.6	10.4	8.3	8.4	7.8

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. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade.

Table 2

City of Zagreb Economic Statistics

	--Fiscal year end Dec. 31--					
	2013	**2014**	**2015**	**2016bc**	**2017bc**	**2018bc**
Population	793,930	795,500	796,000	797,000	798,000	800,000
Population growth (%)	0.1	0.2	0.1	0.1	0.1	0.3
GDP per capita (local currency) (single units)	142,220	140,360	142,890	146,460	150,560	155,380
Unemployment rate (%)	9.5	9.5	13.7	12.5	12.0	12.0

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. Sources typically include national statistical offices, Eurostat, and Experian Limited.

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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

*S&P Global Ratings bases its ratings on local and regional governments (LRGs) on eight main rating factors listed in the table above. Section A of S&P Global Ratings "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

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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
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs - October 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Sovereign Risk Indicators, July 6, 2016. 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
- Research Update: Croatia Ratings Affirmed At 'BB/B'; Outlook Remains Negative, July 15, 2016

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

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

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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