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CREDIT OPINION
8 August 2019

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RATINGS

Zagreb, City of

Domicile	Croatia
Long Term Rating	Ba2
Type	LT Issuer Rating
Outlook	Positive

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Gjorgji Josifov +420.2.2410.6431
AVP-Analyst
gjorgji.josifov@moodys.com

Massimo Visconti +39.02.9148.1124
VP-Sr Credit Officer/Manager
massimo.visconti@moodys.com

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Americas	1-212-553-1653
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Japan	81-3-5408-4100
EMEA	44-20-7772-5454

City of Zagreb (Croatia)

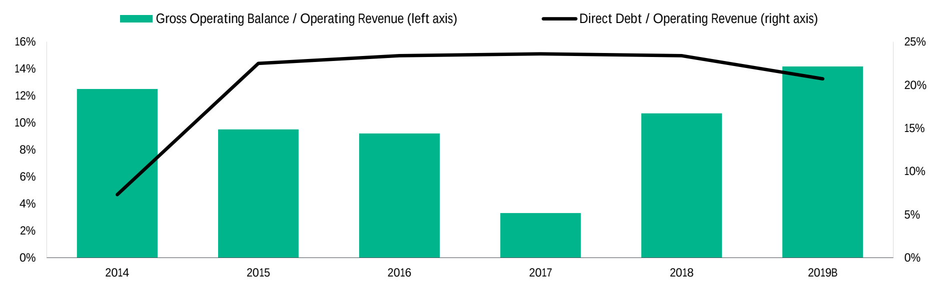
Update to credit analysis

Summary

The credit profile of the City of Zagreb (Ba2 positive) reflects its consistently prudent budgetary management, low direct debt levels, strategic importance as the most developed city in the country, as well as a moderate likelihood that the Government of Croatia (Ba2 positive) would provide support if the city were to face acute liquidity stress. The rating also takes into account the city's healthy capital spending, thus limiting debt accumulation.

Conversely, the rating incorporates the potential pressure stemming from the city's transportation company, Zagrebacki Elektricni Tramvaj (ZET), and the public services provider, Zagrebacki Holding D.O.O. (Zagrebacki Holding, Ba2 positive).

Exhibit 1
Improving operating performance and continued low direct debt levels



B - budget.
Sources: City of Zagreb, Moody's Investors Service

Credit strengths

- Improving and satisfactory operating margin
- Balanced financial results notwithstanding the growing capital spending in 2019-20
- Continued low direct debt regulated by borrowing limits set at the national level
- Importance of Zagreb's role as the economic hub and capital city of Croatia

Credit challenges

- Continuous pressure stemming from Zagrebacki Holding and public transportation
- Improving, but still-low, liquidity
- Limited revenue control under the current institutional framework

Rating outlook

The positive outlook mirrors the positive outlook on the sovereign bond rating. It also reflects our expectation that Zagreb will be able to sustain its comparatively good national economic growth levels, which will in turn result in higher proceeds from shared taxes. The city's track record of prudent budgetary management further supports the positive outlook.

Factors that could lead to an upgrade

Upward pressure on Zagreb's rating could arise from an upgrade of the sovereign rating, while the city maintains its good financial performance and low direct debt levels.

Factors that could lead to a downgrade

Although unlikely, given the recent outlook change to positive from stable, a deterioration in the sovereign credit strength could exert downward pressure on Zagreb's rating, given the close financial, institutional and operational links between the two tiers of governments.

A sustained deterioration in the city's operating performance and a material increase in its debt and debt-servicing needs could also lead to a rating downgrade.

Key indicators

Exhibit 2

Zagreb, City of

	2014	2015	2016	2017	2018
Net Direct and Indirect Debt/Operating Revenue (%)	109.2	112.5	109.6	104.4	89.1
Total Direct Debt/Operating Revenue (%)	22.5	23.4	23.6	23.4	24.2
Cash Financing Surplus (Requirement)/Total Revenue (%)	-14.8	1.8	-3.9	-5.8	-4.1
Gross Operating Balance/Operating Revenue (%)	12.5	9.5	9.2	3.3	10.7
Debt Service/Total Revenue (%)	4.6	5.2	5.1	6.8	5.3
Self-financing Ratio	0.5	1.2	0.7	0.5	0.7
Intergovernmental Transfers/Operating Revenue (%)	1.7	2.4	1.6	5.6	2.5

Sources: City of Zagreb, Moody's Investors Service

Detailed credit considerations

On 30 April 2019, we changed the rating outlook on the City of Zagreb to positive from stable. At the same time, we affirmed its Ba2 global scale rating. The rating action reflects (1) the improvement in the operating environment for Croatian sub-sovereigns, as captured in the rating action on the sovereign bond rating; and (2) the city's good budgetary management and sound financial fundamentals.

The credit profile of the City of Zagreb, as expressed in its Ba2 positive rating, combines (1) a Baseline Credit Assessment (BCA) of ba2; and (2) a moderate likelihood of extraordinary support from the national government in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

Improving and satisfactory operating margin

We expect Zagreb's gross operating balance (GOB) to continue to improve in 2019-20, mainly driven by a combination of favourable economic conditions (we forecast a 2.5% real GDP growth in 2019), which will fuel the city's budget, with higher income tax contributions and increased tax administration efforts, resulting in an expanded tax base. This will bolster the city's tax revenue, contributing to healthy GOBs, boosting its self-funding capacity and limiting debt accumulation.

The positive economic trends associated with the self-imposed budget consolidation measures initiated in 2017 as a response to the negative effects of the tax reform resulted in an improvement in the city's operating performances in 2018, with its GOB at 11% of operating revenue compared with 3% a year earlier.

Zagreb has successfully kept operating spending growth in check through a combination of spending reviews and cost controls over the past few years and this financial prudence will help improve its credit quality. As a result of spending control, the operating cost growth of 4% in 2018 was significantly lower than the operating revenue growth of 12.5%. Given the rigidity in Zagreb's operating spending, these measures were primarily focused on containing the growth of material expenses and transfers and donations.

Costs for personnel, goods and services, representing a high 36% of operating spending, along with the subsidies to city's companies and donations for social programmes (additional 21% of operating spending), limit the city's spending flexibility. Zagreb's contribution to Croatia's equalisation fund is another factor in rising mandatory spending. This transfer from the city's budget reflects the wealth of the local economy from which the city benefits. In 2018, the transfer amounted to HRK700 million (almost 11% of operating spending).

However, the combined effect of an upward trend in the tax revenue, envisaged to increase by 7% in 2019, along with the city's determination to maintain the operating cost control, is likely to lead to a moderate rise in the GOB to 12%-13% of operating revenue in 2019 and around 15% in 2020.

Balanced financial results notwithstanding the growing capital spending in 2019-20

In 2018, the city posted a low financing deficit of 4% of total revenue compared with 6% in 2017. Although the estimated growth in capital spending has the potential to deteriorate the financial performance of the city, we expect it to remain balanced overall in 2019 and revert to the positive territory in 2020, given the projected tax revenue growth, improvement in operating margin and more efficient utilisation of available European Union (EU) funds.

Over the past five years, the city and its institutions received HRK2.3 billion from the EU programmes, covering around 35% of total investments. We expect Zagreb to continue making effective use of new funding opportunities offered by the 2014-20 programming period from EU funds, without exerting excessive pressure on its budget. This will diversify its funding sources for capital investment in 2019-20, with EU funds likely to account for about 35% of the total. A further 40% will come from the city's own operating balance and cash reserves and new borrowing will cover the remaining 25%.

Zagreb increased capital spending on infrastructure projects to HRK1.1 billion in 2018 from HRK0.7 billion in 2017, representing 15% of total spending compared with 11% a year earlier. However, this is projected to increase further to HRK1.4 billion in 2019 and HRK1.5 billion in 2020, or 18% of total planned spending in both years. The capital spending plan focuses on infrastructure, including public transport, road maintenance, social service facilities, healthcare, water supply and sewage, energy efficiency measures and solid waste treatment facilities.

Low direct debt, which is regulated by borrowing limits set at the national level

The city's direct debt stood at HRK1.7 billion, representing a moderate 24% of operating revenue in 2018. We expect the EU and the central government grants to help alleviate Zagreb's financing needs and limit new borrowings for infrastructure investments in 2019-20. In addition, the municipal borrowing in Croatia is constrained by borrowing limits set by the central government. As a result, we expect the city's direct debt levels to remain low at 23% of planned operating revenue in 2019 and 22% by 2020.

Consequently, the city's debt-servicing costs will remain manageable because of low debt levels and favourable repayment schedule, falling to 4.5% of the estimated total revenue in 2019, down from 5.3% as of year-end 2018 and the peak of 6.9% in 2017.

The city's current direct debt consists of six long-term amortising bank loans with domestic banks and three commodity loans.

Importance of Zagreb's role as the economic hub and capital city of Croatia

Zagreb is the capital of Croatia and the country's largest city with 802,000 inhabitants (2017 latest available data), representing 19.2% of the national population. As the capital city, Zagreb contributes significantly to the country's economy, accounting for one-third of the national GDP. With local GDP per capita at 175% of the national average (data as of 2016), Zagreb is Croatia's wealthiest city. It is the base for almost 33% of Croatia's businesses, which provide 26.7% of the country's total employment (data as of December 2018). The city's unemployment rate stood at 4.4% as of year-end 2018, well below the national rate of 9.5%.

Zagreb benefits from a diversified industrial base, which includes food processing, machinery construction, petrochemicals and chemicals, and the light industry. Zagreb is the seat of the central government and hosts the country's main universities and headquarters of Croatia's largest companies.

Continuous strain stemming from its 100%-owned Zagrebacki Holding and public transportation

Zagreb's spending also comes from subsidies and transfers to its 100%-owned Zagrebacki Holding and public transportation company ZET, which, along with the capital payments earmarked for debt repayment costs, accounts for about a quarter of its budget. The holding company provides all core public services on behalf of the city. The major businesses operated by the holding company are extremely important to the city and require its continuous support, either in the form of subsidies or through a regulatory framework.

The loss-making transportation company ZET, which spun off from the Zagrebacki Holding in December 2017 and emerged as a limited liability company under the city's direct control, posted a positive financing result in 2018 for the first time after a long period of generating losses. Notwithstanding the positive financing results, ZET will remain a continuous source of budgetary pressure for the city's budget, given the planned investments, in particular the renewal of the tram and bus fleet, as well as the construction of a cabin lift to Sljeme, estimated at HRK500 million.

Although public transport subsidies decreased over 2013-16, they started to rise following the adjustments in the way the sector is financed and amounted to HRK580 million in 2018. Since 2017, the level of subsidies is based on a new long-term contract, which requires full compensation for public transportation service obligations as well as a fair level of profit (including depreciation), as required by the EU regulations.

The indirect debt exposure arising from Zagrebacki Holding and ZET remains relatively high, with net direct and indirect debt accounting for 89% of operating revenue as of year-end 2018 (down from 104% in 2017). However, the renewed fiscal discipline and tighter control over the Zagrebacki Holding and ZET are in favour of Zagreb's ability to contain financial risks off-balance sheet and limit borrowing requirements. The latest projections suggest that net direct and indirect debt will continue to gradually fall to 82% of operating revenue in 2019.

Improving, but still-low, liquidity

Despite an overall good financial performance, the City of Zagreb has historically held a limited level of cash reserves. The city's liquidity improved in 2018 reaching HRK149 million on average throughout the year, compared with HRK92 million in 2017.

Nevertheless, Zagreb's regular and predictable inflow and outflow throughout the year and its cash-generating capacity provide sufficient cash to cover the city's debt service requirements of about HRK285 million falling due in 2019.

Zagreb does not maintain emergency lines of credit and has never had to use short-term borrowing.

Limited revenue control under the current institutional framework

Croatia's institutional framework for local governments features low financial predictability and stability. Zagreb has very limited control over its revenue base, which consists mainly of a share of personal income taxes (67% of the city's operating revenue in 2018). Local tax revenue represents a minor proportion of municipal revenue. This high fiscal dependence on state decisions exposes municipal finances to the performance of the general government budget and evolving intergovernmental relations. In addition, frequent adjustments to the framework significantly undermine the city's planning ability and the predictability of revenue for municipal finance.

The City of Zagreb's power to raise some additional funds through a surtax on personal income tax partially mitigates the lack of discretionary powers on the revenue side. However, we understand that the city's current surtax on personal income tax is the highest in the country, making any further increase politically sensitive. The containment of spending at the city-owned holding company and the flexibility offered by the large proportion of capital spending within the municipal budget could offer some scope to balance the budget.

We do not expect the composition of Zagreb's operating revenue to change significantly in the near future, given that local finances in Croatia depend on decisions by the central government, leaving local governments with limited leeway regarding taxes and fees.

Extraordinary support considerations

We consider Zagreb to have a moderate likelihood of extraordinary support from the national government, reflecting our assessment of the city's strategic importance to the national economy. The system of oversight implemented by the national government requires regular monitoring of cities' indebtedness.

Rating methodology and scorecard factors

The assigned BCA of ba2 is in line with the scorecard-indicated BCA of ba2. 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 bond rating.

Exhibit 3

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	179.49	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 (%)	3	8.38	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	1	0.95	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	89.09	25%			
Short-term direct debt / total direct debt (%)	3	16.32	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						**2.13(2)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba2**

Sources: City of Zagreb, Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
ZAGREB, CITY OF	
Outlook	Positive
Issuer Rating	Ba2

Source: Moody's Investors Service

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