Research Update:

City of Zagreb Outlook Revised To Negative From Stable On Deteriorating Financial Situation; 'BB' Ratings Affirmed

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Overview

- We believe that the City of Zagreb's financial situation might be burdened from adverse conditions, namely recent earthquakes and continuing costs from the COVID-19 pandemic.
- In our view, Zagreb's creditworthiness might benefit from additional funds from the central government in the medium term.
- We are therefore revising our outlook on the city to negative from stable and affirming our 'BB' long-term issuer credit rating on Zagreb.

Rating Action

On March 27, 2020, S&P Global Ratings revised its outlook to negative from stable and affirmed its 'BB' long-term issuer credit rating on the Croatian city of Zagreb.

Outlook

The negative outlook reflects our view that there is an increased likelihood that Zagreb's budgetary performance might worsen considerably due to the combined effects from the COVID-19 outbreak and earthquakes on March 22.

Downside scenario

We could downgrade Zagreb if the city's financial profile worsened over the next 12 months, with operating performance declining beyond our base-case scenario, due to lower tax revenues and higher spending on repair and public transport stemming from prolonged recession and effects from the earthquake. Increasing carried-forward deficits in national accounting terms could also increase Zagreb's already high debt burden and pressure the city's cash levels, resulting in accumulation of payables.

Upside scenario

We would revise the outlook to stable if over the next 12 months if Zagreb weathered upcoming budgetary challenges without further reducing already-low liquidity reserves.

Rationale

The rating reflects our expectation that the recession following the COVID-19 outbreak will lead to a one-off hit to Zagreb's budgetary performance, and the city will continue to post sound operating surpluses thereafter. We expect that the operating surpluses, together with capital grants, should permit Zagreb to increase its capital expenditure program also to repair damage following two major earthquakes on March 22. We believe the city will increase its borrowings to pay off parts of the accumulated accrued deficit from 2017-2019, but keep overall debt well below 90% of operating revenues. The rating also reflects Zagreb's very weak liquidity position, the volatile policy environment, and the unpredictable institutional framework that is subject to relatively frequent changes.

The institutional framework and financial management limit the city's creditworthiness

In our view, Zagreb's creditworthiness remains constrained by the institutional setup under which Croatian municipalities operate. With the COVID-19 pandemic, the central government announced tax holidays of up to three months for some groups of taxpayers. The cost of these measures to Croatian municipalities, including Zagreb, is unclear, although the central government announced interest-free liquidity support up to the amount of the deferred taxes. The framework changes frequently, and the distribution of resources is unbalanced and not sufficiently aligned to tasks delegated to municipalities. This is highlighted by Zagreb's increased accrued deficit, which reflects the funds the city expects to receive from the central government in compensation for delegated tasks. In addition, multiple changes to the tax system make financial planning difficult.

The unpredictability of the central government's actions constrains policy effectiveness at the city level, limiting Zagreb's ability to effectively plan. The three major expenditure items for the city are education, health care, and maintenance of public space. We view Zagreb's unreliable long-term planning and weak liquidity policies as key management weaknesses. In addition, the use of unconventional debt instruments such as factoring deals, and the sometimes-difficult relationship between the government and city assembly, further limits our management assessment. We assess Zagreb's oversight and control over municipal companies as weak. Although the board of municipal company, Zagrebacki Holding d.o.o., maintains very close ties with the city's management, clear decision-making procedures appear to be lacking.

Zagreb contributes about one-third of total Croatian GDP, and unemployment has been steadily decreasing and well below the national level of 6.5% in 2020, although levels might rise following a recession in 2020. GDP per capita is comparable with that of similarly rated international peers, while about 70% higher than the national average. We forecast national and local GDP per capita will increase similarly, with a contraction in 2020 due to restricted tourism and quarantine measures. We expect an economic rebound in 2021. The pull Zagreb exerts on the country has resulted in a growing population, in contrast to the national trend. This supports the city's economic and tax base to some degree.

COVID-19 will markedly hinder budgetary results in 2020

We expect that the announced tax holidays will lead to a significantly weaker budgetary performance in 2020, with the operating surplus dropping to 8.8% from 10.6% over the previous two years. Supported by underlying economic growth, this ratio should get back to 11%-12% thereafter, enabling Zagreb to deliver on its ambitious capital expenditure program. However, we do not believe that the city will fully execute all capital expenditure budgeted, because in February 2020, the city parliament failed to approve the general urban plan containing the medium-term investments.

Zagreb's budgetary flexibility is limited because most revenue items depend on central government's decisions, and expenditure such as salaries tends to be rigid. The city cannot change its main revenue source, personal income taxes, except for the surtax charged. Expenditure flexibility is constrained also by large inflexible subsidies granted to the municipal holding company, and the now stand-alone Zagrebacki Elektricni Tramvaj (ZET), which both support the city in the supply of essential public services. Asset sales have proven difficult in past years and add no flexibility elements. We assume that the outsourced entities will debt-finance revenue shortfalls due to fee freezes and fewer ticket sales following quarantine measures.

We assume Zagreb will accumulate debt in addition to financing needs over the coming years to help pay off the deficit of the past two years. We therefore forecast rising net new borrowing, both at the city level and at Zagrebacki Holding. In our base-case scenario, we assume that the city's tax-supported debt, which includes debt of other municipal companies and Zagrebacki Holding, will increase to 79% of consolidated operating revenue in 2022 from 70% in 2017. In our view, this is high relative to that of peers in the region, but mitigated by Zagreb's relatively high operating margins. Direct debt is about half the tax-supported debt, reflecting the large outsourcing of debt.

In our view, the city's contingent liabilities are sizable. They consist of Zagrebacki Holding's and ZET's payables, and the long- and short-term debt of related entities not already included in debt. In addition, high exposure to litigation, at 1.1 billion Croatian kunas (HRK), forms part of this assessment, although the city is unlikely to be liable for the full amount. Litigation includes disputes with the Croatian Ministry of Finance.

Zagreb's liquidity situation remains a key credit weakness. Available liquidity is still limited, with Zagreb's cash holdings at year-end 2019 at HRK21 million, which we expect to remain broadly constant, covering only 25% of the next 12 month's debt service. Also, we view access to external liquidity as limited, because Croatia's domestic banking sector is relatively weak, as reflected in our assessment of the banking sector (see "Banking Industry Country Risk Assessment: Croatia," published Oct. 9, 2019, on RatingsDirect).

Key Statistics

Table 1

City of Zagreb--Selected Indicators

	--Fiscal year ended Dec. 31--					
(Mil. HRK)	2017	2018	2019	2020bc	2021bc	2022bc
Operating revenues	6,420	7,223	7,471	7,636	8,137	8,422
Operating expenditures	6,007	6,456	6,676	6,961	7,211	7,461
Operating balance	413	767	795	675	926	961

Table 1

City of Zagreb--Selected Indicators (cont.)

	--Fiscal year ended Dec. 31--					
(Mil. HRK)	**2017**	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**
Operating balance (% of operating revenues)	6.4	10.6	10.6	8.8	11.4	11.4
Capital revenues	152	57	158	360	160	160
Capital expenditures	610	838	1,054	1,005	1,000	1,000
Balance after capital accounts	(45)	(14)	(102)	30	86	121
Balance after capital accounts (% of total revenues)	(0.7)	(0.2)	(1.3)	0.4	1.0	1.4
Debt repaid	709	551	671	396	353	370
Gross borrowings	366	558	593	641	567	549
Balance after borrowings	(388)	0	(180)	275	300	300
Direct debt (outstanding at year-end)	2,197	2,302	2,246	2,230	2,444	2,623
Direct debt (% of operating revenues)	34.2	31.9	30.1	29.2	30.0	31.1
Tax-supported debt (outstanding at year-end)	7,292	7,153	7,097	7,730	7,944	8,123
Tax-supported debt (% of consolidated operating revenues)	69.4	78.4	75.7	81.0	79.1	78.7
Interest (% of operating revenues)	1.3	1.5	0.7	0.6	0.5	0.5
Local GDP per capita (HRK)	152,784	159,057	163,670	165,837	172,881	180,048
National GDP per capita (HRK)	88,841	93,648	98,331	99,902	104,145	108,463

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. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. HRK--Croatian kunas.

Ratings Score Snapshot

Table 2

City of Zagreb--Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	5
Economy	3
Financial management	4
Budgetary performance	2
Liquidity	5
Debt burden	3
Stand-alone credit profile	bb

Table 2

City of Zagreb--Ratings Score Snapshot (cont.)

Key rating factors	Scores
Issuer credit rating	BB

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, Dec. 12, 2019. Interactive version available at http://www.spratings.com/sri

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Croatia, March 20, 2020
- Economic Research: COVID-19 Macroeconomic Update: The Global Recession Is Here And Now, March 17, 2020
- Local Government Debt 2020: Low Growth And High Refinancing Are Fueling European Borrowing, March 2, 2020
- Banking Industry Country Risk Assessment: Croatia, Oct. 9, 2019
- Croatia-Based Zagrebacki Holding d.o.o. 'B+' Rating Affirmed; Outlook Stable, Sept. 9, 2019
- Default, Transition, and Recovery: 2018 Annual International Public Finance Default Study And Rating Transition Study, Aug. 19, 2019
- Global Ratings List: Local And Regional Governments 2019, Aug. 2, 2019
- Institutional Framework Assessments For International Local And Regional Governments, July 4, 2019
- Ratings History List: Europe, Middle East, And Africa Local And Regional Government Ratings Since 1975, March 8, 2019
- Public Finance System Overview: Croatian Municipalities, Feb. 7, 2019

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

Ratings Affirmed; Outlook Action

	To	From
Zagreb (City of)		
Issuer Credit Rating	BB/Negative/--	BB/Stable/--