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**Research Update:**

# Croatian City of Zagreb Affirmed At 'BB'; Outlook Stable

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## Research Update:

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## Overview

- We expect the city of Zagreb will continue posting strong operating margins through 2019, somewhat mitigating the pressure on capital account surpluses, since we expect investments will pick up in 2018-2019.
- In our view, the institutional framework remains volatile, which, alongside relatively weak liquidity coverage, constrains Zagreb's creditworthiness in the medium term.
- We are affirming our 'BB' long-term issuer credit rating on Zagreb.
- The stable outlook reflects our expectation that the city will continue to perform in line with our base-case scenario over 2017-2019 and limit accumulation of debt, both directly and via municipal companies.

## Rating Action

On Sept. 29, 2017, S&P Global Ratings affirmed its 'BB' long-term issuer credit rating on the Croatian city of Zagreb. The outlook is stable.

## Outlook

The stable outlook on Zagreb reflects our view that continued strong operating balances will help counterbalance Zagreb's increased investment plans. Despite our expectations of a slight rise in tax-supported debt in absolute terms, which includes the debt of municipal company Zagrebacki Holding, the city's debt burden will remain low over 2017-2019.

### Downside Scenario

We could downgrade Zagreb if we saw a significant worsening of financial performance and an increase in tax-supported debt to over 120% of consolidated operating revenues. We would also consider revising our assessment of Zagreb's creditworthiness downward if we saw continued pressure on its cash levels, resulting in further deterioration of its liquidity coverage ratio.

### Upside Scenario

Contingent on an upgrade of the sovereign, we could raise the rating if the city structurally improved its liquidity position, resulting in cash and funds available under credit facilities covering yearly debt service sustainably by more than 80%. Additionally, stronger medium- and long-term planning, coupled with strict oversight of municipal companies, could enhance our view of the city's financial management and intrinsic creditworthiness.

## Rationale

The rating reflects our view that the city will continue its trend of high operating balances, exceeding 10% of operating revenues, allowing room for more rapid investments. This should enable the city to avoid excessive debt accumulation and retain its current liquidity position.

Nevertheless, these factors remain counterbalanced by an institutional framework that is subject to relatively frequent changes, revenue and expenditure mismatches, and financial management weaknesses. Zagreb's stand-alone credit profile (SACP) is at 'bb'.

### The institutional framework and financial management limit Zagreb's creditworthiness

In our view, Zagreb's creditworthiness remains constrained by the institutional setup under which Croatian municipalities operate. The framework exhibits frequent changes and an unbalanced distribution of resources that are not sufficiently aligned to tasks delegated to the municipal level. This is exemplified by the latest change to the tax system, which took effect at the beginning of 2017. The tax reform is aimed at easing the tax burden for individuals and companies by decreasing several tax rates and brackets (for example, the maximum rate for personal income tax to 36% from 40%). This effectively diminishes Zagreb's revenue-raising abilities. The reform stipulates that revenue shortfalls that result will be covered by the central government through transfers. However, these transfers have not yet been fully codified by the government. Ultimately, the unpredictability of the central government's actions constrains policy effectiveness at the city, limiting Zagreb's ability to effectively plan for the long term.

Milan Bandic was re-elected to serve as the mayor of Zagreb for a sixth four-year term in June 2017, indicating some stability of the city's management. Nonetheless, we see management's effectiveness as constrained by unreliable long-term planning. The use of unconventional debt instruments such as factoring deals, and a somewhat difficult relationship between the government and city assembly, as shown by the mayor almost being ousted in December 2016, further constrain our management assessment.

The city's management of municipal companies remains weak overall. The board of Zagrebacki Holding maintains very close ties with the city's management, although clear decision-making procedures appear to be lacking. The city provides subsidies to Zagrebacki Holding of about Croation kuna (HRK) 580 million (about $90 million) annually. There have been ongoing discussions between both parties on removing the loss-making transportation company (ZET) from Zagrebacki Holding's portfolio, but a decision has not been taken yet. This is an important decision since it would substantially alter Zagrebacki Holding's financial performance.

Zagreb's economy is diversified. Companies in the city contribute roughly 50% of all corporate profits in the country, and unemployment has been steadily decreasing (7.6% in 2016). The pull the city exerts has resulted in a growing population, which in turn supports the city's economic and tax base. We estimate that the city housed around 798,500 inhabitants, or 19% of Croatia's total population in 2016. Furthermore, the city's management continues to focus on projects intended to promote Zagreb as a tourist and international conference destination. For example, it is building a new center for corporate conferences and a network of cycling paths, among various other projects. In our view, however, these strengths are muted by the country's national GDP per capita, which is the basis for our assessment of Zagreb's economic profile. We forecast GDP per capita at around $15,000 in 2019, increasing broadly in line with sovereign growth trends, but this remains average compared with international peers'.

### Operating surpluses will remain strong, helping keep debt low and limiting the risks from weak liquidity

Looking ahead, we expect that Zagreb will exhibit operating balances averaging 11% of operating revenues between 2017 and 2019, broadly unchanged from our previous review. This is mainly owing to solid economic growth averaging 3%.

In our view, Zagreb's budgetary flexibility is weak. Personal income tax, which the city cannot modify, accounted for roughly 70% of operating revenues in 2016. However, the new 2017 tax reforms are effectively decreasing tax brackets, and personal income surtax is limited at 18%, implying the city's dependence on the central government regarding taxation matters.

Difficult-to-cut personnel and goods and services expenses represented 37% of Zagreb's operating expenditure in 2016, limiting its expenditure flexibility. Furthermore, Zagreb regularly reports payments of subsidies totaling about HRK700 million annually. Although, theoretically, the city has some discretion to reduce subsidies, these costs are relatively inflexible, particularly given the importance they hold for Zagrebacki Holding.

Zagreb's capital program targets transportation infrastructure, street renovations, and social service facilities. Capital expenditures represent approximately 11%-12% of expenditures in 2017-2019 and we forecast they will average about HRK760 million over that period (total of approximately HRK2.3 billion). This, in turn, results in expected surpluses after capital accounts decreasing to approximately 1.4% in 2019 from 2.7% in 2017 as capital expenditures pick up in the later years of our forecast. This is also in line with previous EU-program fund utilization picking up toward the end of the cycle. The city is also contemplating the possible next programming period, and its better utilization, in conjunction with the central government.

The city's strong operating surpluses will help limit debt accumulation over the coming years. We forecast moderate debt intake, principally via Zagrebacki Holding, while debt issued directly by the city is likely to reduce. In our base-case scenario, we assume that the city's tax-supported debt, which also includes debt of other municipal companies and Zagrebacki Holding, will decrease to 89% in 2018 from 94% in 2016. In our view, this level of debt is comparably high relative to that of peers in the region, but is generally neutral to Zagreb's intrinsic creditworthiness, supported by high operating margins. Direct debt, which includes the factoring deals the city services on behalf of Zagrebacki Holding, is forecast to decrease to about HRK2.2 billion in 2019 from around HRK2.4 billion in 2017 (around 35% of operating revenues). However, we cannot rule out the possibility of an increase in debt, if operating balances were to be under pressure and Zagreb needed liquidity.

Zagreb's available liquidity remains limited, with the debt-service coverage ratio just below 60% over the coming 12 months. Zagreb's cash holdings average HRK240 million per month; we factor into our assessment of maturing debt liabilities, loans, factoring deals, and guarantee payments. Additionally, we view access to external liquidity as limited, since Croatia's domestic banking sector is relatively weak; this is reflected in our assessment of the banking sector (see "Banking Industry Country Risk Assessment: Croatia," published Jan. 16, 2017, on RatingsDirect).

In our view, Zagreb's contingent liabilities remain moderate. We factor in Zagrebacki Holding's payables of HRK600 million as well as the long-term and short-term debt of self-supporting entities in analyzing the city's total exposure. The city also has an ongoing legal case against the Ministry of Finance and previously won a verdict relating to its overdue payables. Given that the favorable decision effectively reduced the city's payables and the city made a partial payment to suppliers, its payables now stand at no more than 10% of operating revenues. We estimate that the maximum loss under a stress scenario would be 10%-15% of operating revenues.

## Key Statistics

**Table 1**

**City of Zagreb Key Statistics**

| | --Fiscal Year End Dec. 31-- | | | | |
|---|---|---|---|---|---|
| **(Mil. HRK)** | **2015** | **2016** | **2017bc** | **2018bc** | **2019bc** |
| Operating revenues | 6,161 | 6,376 | 6,774 | 6,969 | 7,182 |
| Operating expenditures | 5,471 | 5,696 | 6,077 | 6,181 | 6,352 |
| Operating balance | 690 | 680 | 697 | 788 | 830 |
| Operating balance (% of operating revenues) | 11.2 | 10.7 | 10.3 | 11.3 | 11.6 |
| Capital revenues | 46 | 51 | 138 | 105 | 95 |
| Capital expenditures | 409 | 750 | 650 | 790 | 820 |
| Balance after capital accounts | 327 | (19) | 185 | 103 | 105 |
| Balance after capital accounts (% of total revenues) | 5.3 | (0.3) | 2.7 | 1.5 | 1.4 |
| Debt repaid | 518 | 525 | 441 | 450 | 461 |
| Gross borrowings | 193 | 444 | 320 | 340 | 350 |
| Balance after borrowings | 2 | (100) | 66 | 0 | 2 |
| Modifiable revenues (% of operating revenues) | 23.8 | 38.3 | 36.1 | 35.6 | 35.1 |
| Capital expenditures (% of total expenditures) | 7.0 | 11.6 | 9.7 | 11.3 | 11.4 |
| Direct debt (outstanding at year-end) | 2,681 | 2,436 | 2,366 | 2,306 | 2,246 |
| Direct debt (% of operating revenues) | 43.5 | 38.2 | 34.9 | 33.1 | 31.3 |

**Table 1**

**City of Zagreb Key Statistics (cont.)**

| | --Fiscal Year End Dec. 31-- | | | | |
|---|---|---|---|---|---|
| **(Mil. HRK)** | **2015** | **2016** | **2017bc** | **2018bc** | **2019bc** |
| Tax-supported debt (outstanding at year-end) | 9,089 | 8,982 | 8,907 | 8,942 | 8,977 |
| Tax-supported debt (% of consolidated operating revenues) | 97.7 | 93.7 | 90.2 | 88.8 | 86.5 |
| Interest (% of operating revenues) | 1.9 | 1.6 | 1.6 | 1.6 | 1.5 |
| Local GDP per capita (single units) | 142,887 | 147,188 | 153,129 | 159,629 | 166,734 |
| National GDP per capita (single units) | 79,810 | 82,754 | 86,261 | 90,011 | 94,109 |

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 kuna.

## Ratings Score Snapshot

**Table 2**

**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' credit ratings on local and regional governments are based 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 government's foreign currency rating.

## Key Sovereign Statistics

- Sovereign Risk Indicators - July 6, 2017. An interactive version is available at www.spratings.com/sri

## 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

- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 8, 2017
- Institutional Framework For Croatian Municipalities Remains Volatile And Unbalanced - January 18, 2017
- Banking Industry Country Risk Assessment: Croatia – January 16, 2017

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 agreed that all key rating factors were unchanged.

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/Stable/-- | BB/Stable/-- |

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website 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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