S&P Global
Ratings

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Research Update:

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

September 27, 2019

Overview

- We believe the city of Zagreb will maintain strong operating surpluses and a small surplus after capital accounts in 2019-2021.
- In our view, the volatile policy environment, unpredictable institutional framework, and very weak liquidity coverage will constrain Zagreb's creditworthiness in the medium term.
- We are therefore affirming our 'BB' long-term issuer credit rating on Zagreb and maintaining the stable outlook.

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Rating Action

On Sept. 27, 2019, 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 reflects our view that persistent strong operating balances will counterbalance Zagreb's increased investment plans and limit substantial debt accumulation. We also anticipate the city will retain its current liquidity levels and adequately manage timely debt repayment.

Downside scenario

We could downgrade Zagreb if the city's financial profile worsened, with contracting operating margins or further increasing carried-forward deficits in national accounting terms. Either of these could ultimately lead to significantly increased debt in the medium term. We would also consider lowering the rating if we saw continued pressure on the city's cash levels, resulting in accumulation of payables or a further fall in cash holdings.

Upside scenario

We could raise the rating if stronger medium- and long-term planning, coupled with reduced accrual deficits and strict oversight of municipal companies, enhanced our view of the city's financial management. Similarly, a more structured decision process between the the central and local governments concerning local government matters could enhance our view of the institutional set up, and consequently the rating. Additionally, we could raise the rating if the city structurally and substantially improved its liquidity position.

Rationale

The rating reflects our expectation that the city's operating surpluses will decline but remain sizable in 2019-2021. The operating surpluses, together with capital grants, should permit more rapid investments as well as pay off part of the accumulated accrued deficit of the past two years. As a result, we believe debt accumulation can be contained and the weak liquidity position will not deteriorate any further.

On the other hand, the ratings on the city are constrained by the volatile policy environment and unpredictable institutional framework that is subject to relatively frequent changes. This causes revenue and expenditure mismatches and pressures financial management and policies.

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 changes frequently and the distribution of resources is unbalanced and not sufficiently aligned to tasks delegated to municipalities. This is exemplified by the multiple changes to the tax system introduced during 2017-2018. For example, the personal income tax (PIT) reform, aimed at easing the tax burden for individuals and companies, reduced the maximum rate for PIT to 36% from 40%. This effectively diminished Zagreb's tax income and revenue-raising abilities. The measure was marginally compensated by an increase in the distribution coefficient in 2018. Strong economic growth has also helped revenue inflow and counterbalanced the negative effects for the municipal level. Nonetheless, the central government put in place an indemnification for revenue shortfalls that result from the new income tax regime through transfers. As these transfers have a ceiling mirroring 2016 income tax revenue, and are set to be phased out from 2021, their positive impact for local finances is limited. The unpredictability of the central government's actions constrains policy effectiveness at the city level, limiting Zagreb's ability to effectively plan for the long term. The three major expenditure items for the city are education, health care, and maintenance of public space.

We consider as key management weaknesses Zagreb's unreliable long-term planning and weak liquidity policies. In addition, the use of unconventional debt instruments such as factoring deals, and the sometimes difficult relationship between the government and city assembly further limit our management assessment.

The city's oversight and control over municipal companies is weak overall. Although the board of municipal company Zagrebacki Holding maintains very close ties with the city's management, clear decision-making procedures appear to be lacking. The 2017 spin-off of the transport company (ZET) from Zagrebacki Holding so far has not strengthened governance or financial performance at either company. However, the aim of the restructuring was to enhance funding and grant sources via European institutions, and to allow for more direct control of the loss-making transport company.

The city alone contributes about one-third of total Croatian GDP, and unemployment has been steadily decreasing (4.4% as of December 2018) and is less than half the national level. GDP per capita is at a level comparable with similarly rated international peers, while about 70% higher than the national average. We forecast national and local GDP per capita will grow at a similar pace. The pull the city exerts has resulted in a growing population, in contrast to the national trend. This supports the city's economic and tax base to some degree. Furthermore, the city's management continues to focus on projects intended to promote Zagreb further as a tourist and international conference destination. In our view, these strengths reflect a more favorable socioeconomic profile for the city compared with national peers.

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

We expect Zagreb will exhibit positive, albeit declining, operating balances of 9%-11% in 2019-2021, supported by solid underlying economic growth. However, the latter is partially offset by contained tax revenue growth stemming from tax legislation effects and pressures on personnel expenditure.

Zagreb's capital program targets transportation infrastructure, street renovations, and social service facilities. Notably, the city is concentrating its resources on bridge renovation and the reconstruction of one of the largest and busiest junctions. Capital expenditure (capex) represents approximately 10% of total expenditure in 2019-2021 and we forecast it will average about Croatian kuna (HRK) 800 million (about €100 million) per year over that period (total of approximately HRK2.4 billion). This, in turn, results in surpluses after capital accounts at an average of 0.6% in 2019-2021 in our forecast years. This is also in line with observations from the previous EU program, whereby fund utilization picks up toward the end of the cycle. 2018 capex somewhat exceeded our prior estimate and asset sales were not executed as envisioned. We have now removed these from our forecast.

In our view, Zagreb's budgetary flexibility is limited. PIT, which accounts for about two-thirds of the city's operating revenue, cannot be changed by Zagreb, except for the surtax charged. Furthermore, PIT is contingent on central government decisions, over which local governments have limited influence. Personnel, combined with goods and services expenses, represented 36% of Zagreb's operating expenditure in 2018, limiting the city's expenditure flexibility. This is exacerbated by large inflexible subsidies granted to the municipal holding company, and the now stand-alone ZET, which both support the city in the supply of essential public services. Asset sales have proven difficult in past years and also add no flexibility elements.

The city's strong operating surpluses should help limit debt accumulation over the coming years, as well as pay off the deficit recorded in the past two years to some extent. After a net debt repayment in 2018, we 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 83% of consolidated operating revenue in 2021 from 70% in 2017. In our view, this is high relative to that of peers in the region, but is generally neutral to Zagreb's creditworthiness, which is supported by high operating margins. We forecast direct debt, which includes the factoring deals the city services on behalf of Zagrebacki Holding, will decline in 2019, after the repayment of a short-term factoring deal worth

HRK308 million contracted in 2018. However, to support capex and the 2017-2018 deficit repayment, we expect a moderate increase to about HRK2.5 billion in 2021 (about 33% of operating revenue) from about HRK2.3 billion in 2018.

In our view, Zagreb's contingent liabilities are sizable. In analyzing the city's total exposure, we factor in Zagrebacki Holding's and ZET's payables, as well as the long-term and short-term debt of related entities not already included in debt. Additionally, high exposure to litigation, at HRK1.1 billion, forms part of this assessment, although this less likely to materialize for the full amount. Litigation includes disputes with the Croatian Ministry of Finance.

Zagreb's available liquidity remains limited, with a debt-service coverage ratio of about 25% over the coming 12 months. Zagreb's cash holdings at year-end 2018 stood at HRK21 million, which we expect to remain broadly constant going forward. We factor into our assessment maturing debt liabilities, factoring deals, and guarantee payments. Additionally, we view access to external liquidity as limited, since 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. 3, 2018, on RatingsDirect).

Key Statistics

Table 1

City of Zagreb Selected Indicators

	--Year ended Dec. 31--					
	2016	**2017**	**2018**	**2019bc**	**2020bc**	**2021bc**
(Mil. HRK)						
Operating revenues	6,376	6,420	7,223	7,369	7,578	7,734
Operating expenditures	5,696	6,007	6,456	6,564	6,843	7,101
Operating balance	680	413	767	805	735	633
Operating balance (% of operating revenues)	10.7	6.4	10.6	10.9	9.7	8.2
Capital revenues	51	152	57	120	120	100
Capital expenditures	750	610	838	900	850	625
Balance after capital accounts	(19)	(45)	(14)	25	5	108
Balance after capital accounts (% of total revenues)	(0.3)	(0.7)	(0.2)	0.3	0.1	1.4
Debt repaid	525	709	551	678	496	453
Gross borrowings	444	366	558	750	600	450
Balance after borrowings	(100)	(388)	0	97	109	106
Direct debt (outstanding at year-end)	2,436	2,197	2,302	2,408	2,524	2,533
Direct debt (% of operating revenues)	38.2	34.2	31.9	32.7	33.3	32.8
Tax-supported debt (outstanding at year-end)	8,982	7,292	7,153	7,559	7,975	8,284
Tax-supported debt (% of consolidated operating revenues)	93.7	69.4	78.4	80.6	82.4	83.4
Interest (% of operating revenues)	1.6	1.3	1.5	1.7	2.0	2.2

Table 1

City of Zagreb Selected Indicators (cont.)

	--Year ended Dec. 31--					
	2016	2017	2018	2019bc	2020bc	2021bc
Local GDP per capita (single units)	147,166	152,784	159,057	165,228	171,385	177,598
National GDP per capita (single units)	84,170	88,651	93,363	98,146	102,519	106,768

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. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

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
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, July 11, 2019. An interactive version is 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

- Summary: Croatia, Sept. 20, 2019
- Croatia-Based Zagrebacki Holding d.o.o. 'B+' Rating Affirmed; Outlook Stable, Sept. 9, 2019
- 2018 Annual International Public Finance Default 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
- Local Government Debt 2019: Economic Slowdown Is Set To Spur European LRG Borrowings In 2019-2020, Feb. 25, 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	
Zagreb (City of)	
Issuer Credit Rating	BB/Stable/--

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.