MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
21 June 2017

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RATINGS

Zagreb, City of

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

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.

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Zagreb, City of

Update to Key Credit Rating Factors

Summary Rating Rationale

The City of Zagreb's Ba2 issuer rating reflects its satisfactory operating surpluses, which we expect to benefit from improved growth forecasts for the Croatian economy over the next two years. The rating also takes into account: the city's conservative capital spending plans, which will help it to maintain a sound financial performance; a relatively low direct debt burden; and the crucial role Zagreb plays in the national economy as the Croatian capital.

The rating also reflects continuous pressure on Zagreb's finances stemming from the city's public services provider, 100%-owned Zagrebacki Holding D.O.O. (Ba2 stable), as well as Zagreb's historically low cash reserves. Limited revenue control and predictability under a still evolving institutional framework for local governments is a further constraint on the rating.

Credit Strengths

» Satisfactory operating margins

» Low direct debt regulated by borrowing limits set at national level

» Conservative capital spending plans

» Crucial role in the national economy

Credit Challenges

» Continuous pressures stemming from 100%-owned utility company

» Low cash reserves

» Limited revenue control under Croatia's current framework for local governments

Rating Outlook

The rating outlook is stable.

Factors that Could Lead to an Upgrade

» Upward pressure on Zagreb's rating could arise from an upgrade of the sovereign rating.

Factors that Could Lead to a Downgrade

» Downward pressure on the rating could result from a downgrade of Croatia's sovereign rating, a sustained deterioration in the city's operating performance or a material increase in debt and debt-servicing needs.

» Budgetary pressures stemming from potential deterioration in Zagrebacki Holding's financial performance and an increasing need for support could put downward pressure on the city's rating.

Key Indicators

Exhibit 1
Key Indicators

Zagreb, City of	2012	2013	2014	2015	2016
Net Direct and Indirect Debt/Operating Revenue (%)	111.6	96.9	109.2	112.5	109.6
Total Direct Debt/Operating Revenue (%)	8.4	7.3	22.5	23.4	23.6
Cash Financing Surplus (Requirement)/Total Revenue (%)	-0.5	9.2	-14.8	1.8	-3.9
Gross Operating Balance/Operating Revenue (%)	14.4	22.1	12.5	9.5	9.2
Debt Service/Total Revenue (%)	3.1	2.6	4.6	5.2	5.1
Self-financing Ratio	1.0	1.6	0.5	1.2	0.7
Intergovernmental Transfers/Operating Revenue (%)	0.7	0.8	1.7	2.4	1.6

Source: Moody's Investors Service, City of Zagreb

Detailed Rating Considerations

Zagreb's rating combines (1) its baseline credit assessment (BCA) of ba2; and (2) a moderate likelihood of extraordinary support from the national government in the event the city faces acute liquidity stress.

Baseline Credit Assessment

Satisfactory operating margins

Zagreb's operating revenue grew by 3% in 2016 after two consecutive years of decline, with the city's major source of revenue, personal income tax, growing by 6%, boosted by national GDP growth of 2.9%. The growth in operating revenue, however, was offset by a similar increase in operating expenditure. As a result, the city's gross operating balance (GOB) was little changed compared with 2015 at 9.2% of operating revenue. The GOB is at a satisfactory level, providing the city with sufficient resources to service debt, but it is significantly below the average of 16% for the 2009-14 period.

We expect economic recovery to continue to support operating revenue growth over the next two years, with Croatian GDP growth of 3% in 2017 and 2.5% in 2018, according to our forecasts. In addition, the central government will devise a new model of financing for local and regional governments during 2017-18 that will adjust the municipal share of property tax and personal income tax revenue. The changes should support a return in Zagreb's GOB to low double-digit levels in the next two years, shoring up the city's recently weakened capacity to self-fund its large infrastructure needs.

Zagreb's sound governance and management practices, as well as its clearly defined internal policies and procedures, have supported the city's operations and help to mitigate the limited predictability of the evolving financial framework. The City of Zagreb consistently provides comprehensive financial documents in compliance with legislative requirements.

Conservative capital spending plans

Despite the city's infrastructure needs remaining high, it has usually been able to keep its capital spending in line with available funding, as reflected in its good, albeit volatile, financial performance.

The city recorded an exceptional double-digit financial deficit of almost 14.8% in 2014 when capital spending hit a five-year peak of HRK1.85 billion. The high level of capital spending was caused by the extraordinary purchase of two non-operating properties, Gredelj and Zagrepcanka, from Zagrebacki Holding. The transaction was designed to support Zagrebacki Holding's financial restructuring, which was funded by new borrowing. Zagrebacki Holding used the HRK961 million in proceeds from the property sales to service overdue commercial payables and reduce its debt burden, and consequently the indirect debt of the city.

A 50% reduction in capital spending compared with initial plans enabled the city to return to a financial surplus of almost 2% of total revenue in 2015, followed by a deficit of 3.9% in 2016. The city's 2017-19 budget forecasts assume a return to a balanced financial performance, with only limited recourse to new debt.

Lower operating margins led to a reduction in capital spending from an average of 19% of total expenditure in 2009-14, to just 8.6% in 2015 and 13.3% in 2016. The 2017-19 budget forecasts envisage higher investment of around 18% of total expenditure, or HRK1.3 billion annually. The capital spending plan focuses on the city's social service facilities, infrastructure including public transport, and the environment. Aside from relying on its own revenue and, partially, borrowing, the city applies for funds from the European Union, which will likely ease its infrastructure funding needs in the medium term. Under the EU's 2014-20 programming period, the city has applied for funds for projects that have a total value of HRK562 million. The value of projects that have been approved so far totals almost HRK170 million. The city is also carrying out a number of investment projects through Zagrebacki Holding.

Low direct debt regulated by borrowing limits set at national level

The city's direct debt was manageable at 23.6% of operating revenue in 2016. It forecasts direct debt will remain around 20% in 2017-18, as planned borrowing should remain below scheduled repayments and is constrained by borrowing limits set by the central government.

The city's direct debt of HRK1.51 billion at year-end 2016 consisted of seven long-term amortising bank loans on investment projects and four commodity loans. Zagreb's debt-servicing costs remain manageable thanks to a favourable repayment schedule. They amounted to 5.2% of operating revenue in 2016 and are likely to remain at a similar level in 2017-19.

Crucial role in the national economy

Zagreb is the capital of Croatia and the country's largest city with almost 800,000 inhabitants, representing 19% of the national population. As the capital city, Zagreb contributes significantly to the country's economy, accounting for one-third of national GDP. With local GDP per capita at 176% of the national average (2014 latest available data), Zagreb is Croatia's wealthiest city. It is the base for almost 33% of Croatia's businesses, which provide 39% of the country's total employment (2015 latest available data).

Zagreb benefits from a diversified industrial base, which includes food processing, machinery construction, petrochemicals and chemicals, and 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 pressures stemming from 100%-owned utility company

Zagreb's 100%-owned Zagrebacki Holding provides all of the city's core public services. 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. Payments to the company are among the main drivers of Zagreb's spending, accounting for one quarter of its budget.

Public transport, in particular, is a continuous source of budgetary pressure. Though public transport subsidies decreased over 2013-16, they are likely to start rising following adjustments in the way the sector is financed. From 2017, the level of subsidies will be based on a new long-term contract that requires full compensation for public transport service obligations as well as a fair level of profit (including depreciation), as required under EU regulations. Thus, to avoid a financial loss in 2017, subsidies for the transport company, including the payment of tram lease costs, should increase from the budgeted HRK486 million to HRK619 million, according to the company's 2017 business plan. However, final financing needs will be subject to negotiation and might be partially mitigated by continuous streamlining efforts in the transport company.

Operating and capital subsidies to the holding company reached HRK697 million, or 10% of total expenditure, in 2016. Out of those subsidies, HRK109 million was earmarked for Zagrebacki Holding's long-term debt repayment costs.

Zagrebacki Holding's declining, but still very high level of debt represents the City of Zagreb's only indirect debt exposure, totaling HRK5.48 billion at year-end 2016 compared with HRK6.39 billion at year-end 2012. Zagreb's indirect debt comprises holding company debt it has guaranteed or unsecured debt incurred by the holding company. The level of guaranteed debt will significantly increase to around 36% of the city's debt by the end of 2017 from less than 5% at year-end 2015. The increase is due to a new guarantee provided by the city on a bond issue to refinance a euro bond due in July 2017. As such almost half of the holding company's debt will bear an unconditional guarantee from the city, confirming recognition of the holding company's debt as the city's obligation.

The city's combined net direct and indirect debt reached 109.6% of operating revenue in 2016, down from 112.5% in 2015. In 2017, Zagreb's net direct and indirect debt is expected to fall to 100% of operating revenue, and continue declining in the next two years, according to recent forecasts.

Low cash reserves

Despite an overall good financial performance, the city of Zagreb has historically held a limited level of cash reserves. They reached a very low HRK60 million at the end of 2016, or 1% of operating revenue, down from HRK150 million the previous year.

Nevertheless, the city's regular and predictable inflows and outflows throughout the year and its cash-generating capacity provided it with sufficient average monthly liquidity of HRK307 million in 2016, covering the city's debt service requirements of about HRK265 million falling due in 2017.

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

Limited revenue control under current 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 (71% of the city's revenue in 2016). Local tax revenues represent 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.

Partially mitigating the lack of discretionary powers on the revenue side, the City of Zagreb has the power to raise some additional funds through a surtax on personal income tax (PIT). However, we understand that the city's current PIT surtax is the highest in the country, making any further increase politically sensitive. Containing expenditure on the city-owned holding company and the flexibility offered by the large proportion of capital expenditure 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 only limited leeway with regards to taxes and fees.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government reflects Moody's assessment of the central government's promotion of greater accountability for cities, coupled with relatively strong oversight over local government finances.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Zagreb, the BCA matrix generates an estimated BCA of ba2, which is in line with the BCA assigned by the rating committee. 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 rating (Ba2 stable).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

Rating Methodology and Scorecard Factors

Exhibit 2
BCA Scorecard

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	176.91	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	9.76	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	3	1.29	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	109.60	25%			
Short-term direct debt / total direct debt (%)	3	14.90	25%			
Factor 4: Governance and Management						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**2.35(2)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba2**

Source: Moody's Investors Service

Ratings

Exhibit 3

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

Source: Moody's Investors Service

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