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CREDIT OPINION
2 May 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
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City of Zagreb (Croatia)

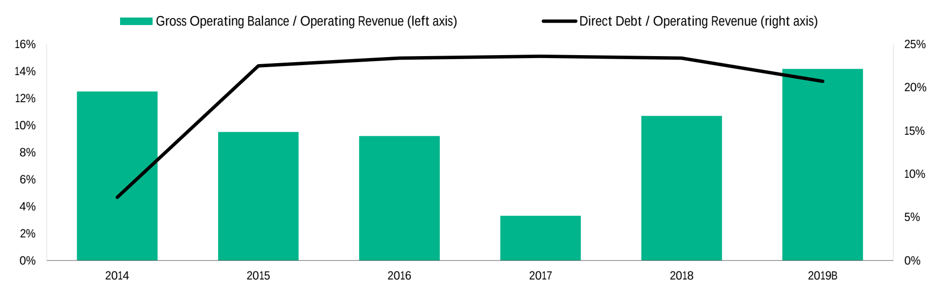
Update following change in outlook to positive

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 and populated 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 public services provider, Zagrebacki Holding D.O.O. (Ba2 positive), which continues to serve as an operational arm of the city. Limited revenue control and predictability under the institutional framework, which exhibits frequent changes, is another constraining factor for the rating.

Exhibit 1
Improving operating performance and continued low direct debt levels



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

Credit strengths

» Improving and satisfactory operating margin

» Healthy capital spending, with a low potential to weaken the city's financial strength

» Continued low direct debt regulated by borrowing limits set at the national level

» A crucial role as the economic hub and capital city of Croatia

Credit challenges

» Continuous pressures stemming from its 100%-owned utility company and city public transport

» Improving but still-low liquidity

» Limited revenue control under the current institutional framework

Rating outlook

The positive outlook reflects our expectation that Zagreb will be able to sustain its comparatively good national economic growth levels, which will in turn result in growing 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, associated with a continuation of the city's 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

City of Zagreb

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 to positive from stable the outlook on the rating of the City of Zagreb. 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

Positive economic trends associated with 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 gross operating balance (GOB) at 11% of operating revenue compared with 3% a year earlier.

We expect its GOB to continue to improve in 2019-20, mainly driven by a combination of favorable economic conditions (we forecast a 2.4% real GDP growth in 2019), which will fuel the city's budget, with higher income tax contributions and increased tax administration efforts, resulting in expanded tax base. This will bolster the city's tax revenue, contributing to healthy GOBs, boosting its self-funding capacity and limiting debt accumulation.

Improvements in tax administration and a number of tax initiatives introduced in 2017 additionally enhanced Zagreb's revenue (doubling the income from property taxes), and also added to higher and potentially less volatile revenue bases. This positive trend is envisaged in the budget for 2019 and projection for 2020. Given the rigidity in Zagreb's operating expenditure, these measures were primarily focused on containing the growth of material expenses and transfers and donations. As a result of spending control, the operating cost growth of 4% in 2018 was significantly lower than the operating revenue growth of 12%.

Costs for personnel, goods and services, representing a high 40% of operating expenditures on average over the past several years, along with the subsidies and donations (additional 20% of operating expenditures), limit the city's expenditure flexibility. Zagreb's contribution to Croatia's equalization 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 should have amounted to around HRK700 million (almost 11% of operating expenditures).

However, the combined effect of an upward trend in the tax revenue, envisaged to increase by 8%-9% 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, given the city's proven capacity and willingness to adjust its budget to economic conditions and revenue dynamics.

Healthy capital spending with a low potential to weaken the city's financial strength

Despite Zagreb's infrastructure needs remaining high, the city has usually been able to keep its capital spending in line with the available funding, as reflected in its good, although volatile, financial performance. Increased tax revenue will help Zagreb achieve its long-term spending program and take advantage of infrastructure funding opportunities during the current European Union (EU) programming period, without putting its budget under additional pressure.

Zagreb's capital spending declined following a gradual decline in its operating margin, with spending on infrastructure averaging 11% of total expenditure between 2015 and 2017. However, the 2019 budget and plan for 2020 indicate that the city is likely to scale up spending on infrastructure, with capital spending amounting to HRK1.4 billion annually or 18% of projected total expenditure. The capital spending plan focuses on the infrastructure including public transport, road maintenance, social service facilities, congress center and the solid waste treatment facility.

Around 35% of Zagreb's capital spending is likely to be funded by the EU's structural and investment funds, a further 40% will come from the city's own operating balance and cash reserves and new borrowings will cover the remaining 25%.

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 improvement in operating margin and more efficient utilization of available EU funds.

Low direct debt 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 22% of estimated operating revenue by 2020.

Consequently, the city's debt-servicing costs will remain manageable, falling to around 5% of estimated total revenue by 2020, 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 amortizing bank loans and three commodity loans.

A crucial 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 (2016 latest available data), representing 19% 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 176% of the national average (2016 latest available data), Zagreb is Croatia's wealthiest city. It is the base for almost 33% of Croatia's businesses, which provide 27% of the country's total employment (January 2018; latest available data).

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 pressures stemming from its 100%-owned utility company and city public transport

Zagreb's spending also comes from subsidies and transfers to its 100%-owned Zagrebacki Holding, which, along with the capital payments earmarked for debt repayment costs, accounts for about one 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.

Public transport, in particular, is a continuous source of budgetary pressure. Although public transport subsidies decreased over 2013-16, they started to rise following the adjustments in the way the sector is financed. As of 2017, the level of subsidies was based on a new long-term contract that required full compensation for public transport service obligations as well as a fair level of profit (including depreciation), as required by the EU regulations.

The indirect debt exposure arising from the city's owned Zagrebacki Holding and transport company Zagrebacki Elektricni Tramvaj (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 increased control over the Zagrebacki Holding speak in favor 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 position improved in 2018 reaching HRK149 million on average throughout the year compared with HRK92 million in 2017.

Nevertheless, Zagreb's regular and predictable inflows and outflows 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.

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. 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. Containing expenditure 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 only limited leeway with regard to 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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