S&P Global Ratings

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Research Update:

City of Zagreb Downgraded To 'BB-' On Reconstruction Costs; Outlook Negative

September 25, 2020

Overview

- The city of Zagreb will have to cover 20% of reconstruction costs related to the March earthquakes, significantly increasing its contingent liabilities.
- We also expect that the city's budgetary performance will deteriorate in 2020 and 2021, due to COVID-19-related shortfalls in tax revenue and additional expenditure.
- We are therefore lowering our long-term issuer credit rating on Zagreb to 'BB-' from 'BB'.
- The outlook is negative because we consider that Zagreb might accumulate payables, putting further pressure on its tight liquidity.

Rating Action

On Sept. 25, 2020, S&P Global Ratings lowered its long-term issuer credit rating on the Croatian capital city of Zagreb to 'BB-' from 'BB'. The outlook is negative.

Outlook

The negative outlook reflects our view that Zagreb might accumulate payables, squeezing its already tight liquidity. As reconstruction of the areas devastated by the March earthquakes is about to begin, we note that it is unclear where the city will get funding for its share of the costs.

Downside scenario

We could downgrade Zagreb if the city's financial profile worsened over the next 12 months, with the accumulation of payables or larger budgetary deficits than we forecast in our base-case scenario, while the financing of upcoming capital expenditure remains vague.

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Upside scenario

We would revise the outlook to stable over the next 12 months if Zagreb secures funding from the central government or the EU for upcoming costs without increasing its already high debt.

Rationale

We have lowered our long-term rating on Zagreb, given our view that its contingent liabilities will increase substantially in light of a newly passed law under which the city will have to cover 20% of repair costs from the March earthquakes. According to current estimates, the cost to Zagreb may exceed the city's annual budget by more 2x, although it would be spread over more than a decade.

We also expect that the city's budgetary performance will deteriorate in 2020 and 2021, due to COVID-19-related shortfalls in tax revenue and additional expenditure. That said, we believe that the central government will compensate Croatian municipalities, including the city of Zagreb, for tax shortfalls following the upcoming tax reform in 2021, which should also mitigate the drop in tax revenue from the pandemic. We believe that the city will increase its borrowings to pay off part of the deficit accrued from 2017-2019, but keep overall debt well below 90% of operating revenue. The rating also reflects Zagreb's very weak liquidity, volatile policy environment, and unpredictable institutional framework that is subject to relatively frequent changes.

Central government support to offset some tax revenue shortfalls, but revenue uncertainty remains

In view of COVID-19, the central government announced tax holidays of up to three months for some groups of taxpayers. The cost of these measures to Croatian municipalities was covered by interest-free liquidity support up to the amount of deferred taxes; Zagreb received over Croatian kuna (HRK) 350 million (about €46 million), which we understand it does not need to pay back. The central government also announced as part of its economic support package that taxpayers' personal income tax will be lowered from 2021, and that it will compensate municipalities for their share of lower revenue. However, the amount of these additional transfers is still unclear. In addition, the central government intends to abolish the property transfer tax, which is a major revenue source for Zagreb, adding to the uncertainties about the city's future revenue.

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 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 lack of minimum cash holding targets 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, since municipal companies, including but not limited to Zagrebacki Holding d.o.o., appear to lack clear decision-making frameworks and continue to depend on the city for support.

Zagreb benefits from its role as Croatia's economic center. The city contributes about one-third of total Croatian GDP, and unemployment has been steadily decreasing and was well below the national level of 9.2% 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 develop similarly, with a contraction of about 8% forecast for 2020 due to restricted tourism and quarantine measures to fight the pandemic. We expect an economic rebound with GDP growth rates exceeding 5% in 2021, with Zagreb participating equally in the rebound. 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.

Zagreb required to cover 20% of costs from earthquake damage

In early September 2020, the national parliament passed a law that states local governments will need to cover 20% of the reconstruction cost for two earthquakes that took place in March. Under the law, the central government will cover 60%, and private owners 20% (so-called "Rule 60-20-20"). We note that current estimates for the costs are about HRK86 billion for the 25,000 buildings that were damaged by two earthquakes on March 22, 2020, in Zagreb, and nearly 1,000 buildings in the neigboring counties. This leaves the city with costs of about HRK17 billion, which is more than twice its annual budget. We acknowledge that the reconstruction efforts will be spread over at least a decade, and Zagreb's corresponding share in the funding might be subject to support from the central government and the EU.

We are convinced that rising needs to fund capital expenditure will lead to deficits after capital accounts over the next few years. We expect that the tax shortfalls following the economic recession will be covered by transfers from the central government, leaving the operating balance between 6%-13% of operating revenue in our 2020-2022 base case. Zagreb's budgetary flexibility is limited because most revenue items depend on the central government's decisions, and expenditure items like 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 recent years and add no flexibility. 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 accumulated over past 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 Zagrebacki Holding and other municipal companies, will peak at about 85% of consolidated operating revenue in 2021 and decline slowly thereafter. In our view, this is high compared with that of peers in the region, but somewhat mitigated by Zagreb's relatively high operating margins. Direct debt is less than half the tax-supported debt, reflecting the large outsourcing of debt.

Zagreb's largest contingent liability is its share of the earthquake damage, which we calculate at about HRK17 billion, equivalent to 220% of the city's operating revenue expected for 2020. In addition to this challenge, the city's other contingent liabilities contribute to our assesment of Zagreb's liability situation as a rating weakness. We include in this assessment Zagrebacki Holding's and ZET's payables, as well as the long- and short-term debt of related entities not already included in tax-supported debt. In addition, high exposure to litigation is a potential threat to the city's financial situation, with potential costs totaling HRK1.3 billion at year-end 2019. We consider it likely that the city will not be liable for the full amount, since litigation includes disputes with the Croatian Ministry of Finance, however the size of contingencies is extraordinary.

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 and will not be remotely sufficient to cover the next 12 months of debt service or upcoming deficits. 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).

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety

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	7,611	7,737	8,422
Operating expenditures	6,007	6,456	6,676	6,669	7,211	7,461
Operating balance	413	767	795	942	526	961
Operating balance (% of operating revenues)	6.4	10.6	10.6	12.4	6.8	11.4
Capital revenues	152	57	158	360	500	500
Capital expenditures	610	838	1,054	1,400	1,500	1,500
Balance after capital accounts	(45)	(14)	(102)	(98)	(474)	(39)
Balance after capital accounts (% of total revenues)	(0.7)	(0.2)	(1.3)	(1.2)	(5.8)	(0.4)
Debt repaid	709	551	671	396	353	370
Gross borrowings	366	558	593	494	827	409
Balance after borrowings	(388)	0	(180)	(0)	0	0
Direct debt (outstanding at year-end)	2,197	2,302	2,246	2,230	2,704	2,743
Direct debt (% of operating revenues)	34.2	31.9	30.1	29.3	34.9	32.6
Tax-supported debt (outstanding at year-end)	7,292	7,153	8,931	8,915	9,389	9,428
Tax-supported debt (% of consolidated operating revenues)	69.4	78.4	82.5	81.3	84.6	80.0
Interest (% of operating revenues)	1.3	1.5	0.7	0.6	0.5	0.5
Local GDP per capita (single units)	152,784	159,057	163,670	165,837	172,881	180,048

Table 1

City of Zagreb -- Selected Indicators (cont.)

	--Fiscal year ended Dec. 31--					
(Mil. HRK)	2017	2018	2019	2020bc	2021bc	2022bc
National GDP per capita (single units)	88,841	93,657	98,378	91,053	97,308	102,429

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

Zagreb (City of) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	5
Economy	3
Financial management	4
Budgetary performance	3
Liquidity	5
Debt burden	4
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

Croatia 'BBB-/A-3' Ratings Affirmed; Outlook Stable, Sept. 18, 2020

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Comparative Statistics: European Local And Regional Government Risk Indicators, June 30, 2020
- Economic Research: Eurozone Economy: The Balancing Act To Recovery, June 25, 2020
- City of Zagreb Outlook Revised To Negative From Stable On Deteriorating Financial Situation; 'BB' Ratings Affirmed, March 27, 2020
- Local Government Debt 2020: Low Growth And High Refinancing Are Fueling European Borrowing, March 2, 2020
- Croatia BICRA Economic Risk Trend Now Negative On Deepening COVID-19 Risks; No Ratings Affected, May 19, 2020
- Banking Industry Country Risk Assessment: Croatia, Oct. 9, 2019
- Croatia-Based Zagrebacki Holding 'B+' Rating Affirmed Amid Weak Liquidity; Outlook Negative, July 27, 2020
- Default, Transition, and Recovery: 2018 Annual International Public Finance Default Study And Rating Transition Study, Aug. 19, 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

Downgraded

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