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CREDIT OPINION
9 July 2018

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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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City of Zagreb (Croatia)

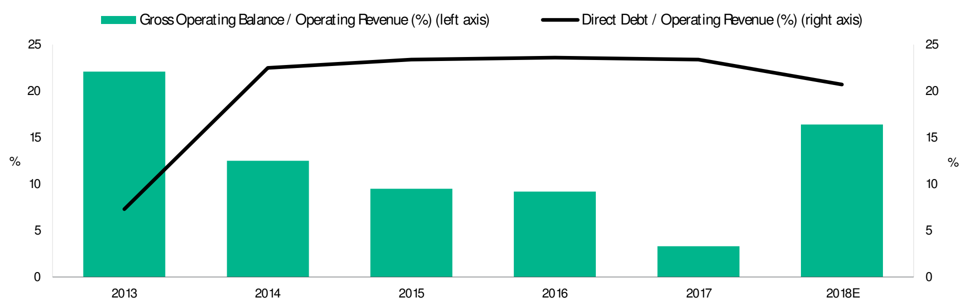
Update to credit analysis

Summary

The credit profile of the City of Zagreb (Ba2 stable) reflects its consistently prudent budgetary management, moderate 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 stable) would provide support if the city were to face acute liquidity stress. The rating also takes into account the city's low capital spending over the past three years, thus limiting the debt accumulation.

Conversely, the rating incorporates the potential pressure stemming from the city's public services provider, Zagrebacki Holding (Ba2 stable), which continues to serve as an operational arm of the city. Limited revenue control and predictability under the institutional framework which exhibits frequent changes, represents another constraining factor for the rating.

Exhibit 1
Satisfactory operating margins expected to improve; moderate direct debt levels



Source: City of Zagreb, Moody's Investors Service; E - estimate

Credit strengths

» Declining, but still satisfactory operating margins

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

» Conservative capital spending, set to grow in 2018-19

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

Credit challenges

» Continuous pressures stemming from 100%-owned utility company

» Weak liquidity position

» Limited revenue control under the current institutional framework

Rating outlook

The stable 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 stable 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 the city's ability to maintain its overall good financial performance and moderate direct debt levels.

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 sharp increase in debt and debt-servicing costs could have a negative effect on the rating.

» Material pressure 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 2

Zagreb, City of

	2013	2014	2015	2016	2017
Net Direct and Indirect Debt/Operating Revenue (%)	96.9	109.2	112.5	109.6	104.4
Total Direct Debt/Operating Revenue (%)	7.3	22.5	23.4	23.6	23.4
Cash Financing Surplus (Requirement)/Total Revenue (%)	9.2	-14.8	1.8	-3.9	-5.8
Gross Operating Balance/Operating Revenue (%)	22.1	12.5	9.5	9.2	3.3
Debt Service/Total Revenue (%)	2.6	4.6	5.2	5.1	6.8
Self-financing Ratio	1.6	0.5	1.2	0.7	0.5
Intergovernmental Transfers/Operating Revenue (%)	0.8	1.7	2.4	1.6	5.6

Source: City of Zagreb, Moody's Investors Service

Detailed credit considerations

The credit profile of the City of Zagreb, as expressed in its Ba2 stable 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 faced acute liquidity stress.

Baseline credit assessment

Declining, but still satisfactory operating margins

Zagreb's operating margin dropped to a still satisfactory 3.3% of operating revenues in 2017 from the average of 9.4% in 2015-16. Last year, the city's operating revenue increase of marginal 0.7% was not sufficient to cover a 7.2% increase of operating expenditures. The amendments in the Law on Income Tax effective from January 2017, aimed to elevate the tax burden for businesses by decreasing tax rates, added pressure to the city's finances. Following the legislative changes, the city's share of the income tax decreased to HRK4.31 billion in 2017 from HRK4.53 billion a year before. Such a decline, an equivalent of 3.6% of operating revenues, posed a credit risk to Zagreb because contributions from the income tax are the city's key revenue source. In 2017, Zagreb derived 67% of its operating revenues from the proceeds of income taxes.

The City of Zagreb responded by implementing some cost-cutting measures throughout the year, which slowed down the growth of operating expenditure. However, costs for personnel, goods and services, representing a high 37% of operating expenditures in 2017, along with the subsidies and donations (additional 22% of operating expenditures), limit the city's expenditure flexibility. Zagreb's contribution to Croatia's equalisation fund is another factor in rising mandatory spending. This transfer from the city's budget reflects the wealth of local economy from which the city benefits. In 2017, the transfer amounted to HRK700 million (11% of operating expenditures) and it is expected to remain at similar levels in 2018.

In 2018, we expect the city's operating revenue to grow by 9% as a result of the forecasted national economic growth of 2.8% (Moody's forecast), with the city's major source of revenue, personal income tax, growing by 18%. In addition, the changes in the Property Tax Act, which took effect at the beginning of 2018, should slightly improve the collections from local taxes. According to the budgetary results of H1 2018, we expect the growth in operating revenue to exceed the increase in operating expenditure. As a result, the city's operating margin should return to low double-digit levels, providing sufficient resources for debt servicing and partly funding the projected growth of capital investment.

Conservative capital spending, set to grow in 2018-19

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

Lower operating margins led to a reduction in the city's capital spending. Zagreb's capital expenditure programme has significantly scaled down over the past three years averaging 10.9% of total expenditures compared with 20.5% during 2013-14. The 2018 budget and plan for 2019 indicate higher capital investment of around 18% of total expenditure or HRK1.3 billion annually. The capital spending plan focuses on the infrastructure including public transport, road maintenance, social service facilities, congress center and the solid waste treatment facility.

In 2017, the city posted a low financing deficit of 5.8% of total revenue compared with 3.8% in 2016. Although the estimated growth of capital expenditures has the potential to deteriorate the financial performance of the city, we expect that it will remain overall balanced given the projected improvement of operating margin and more efficient utilization of available EU funds.

The city is envisaging to increase the utilization of the available European Union (EU) funds under the current programming period. According to the city's estimations approximately 40% of the eligible EU supported investments totaling HRK1.1 billion will be funded from the EU structural and investment funds and the rest will be covered from the city's own budget and new debt. 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 stood at HRK1.5 billion representing moderate 23.4% of operating revenues in 2017. We expect that the city's direct debt will remain at around 20% in 2018-19, as planned borrowing should remain below scheduled repayments and is constrained by borrowing limits set by the central government.

The city's direct debt at year-end 2017 consisted of six long-term amortising bank loans used for investment projects and three commodity loans. Zagreb's debt-servicing costs remain manageable thanks to a favourable repayment schedule. Debt service costs were 6.9% of operating revenue, an increase from 5.2% in 2016 and will return to around 5% in 2018-19.

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 national GDP. With local GDP per capita at 175.5% of the national average (2015 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). At the beginning of this year, Zagreb's unemployment rate was 5.9% compared with national average of 12.5%.

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 spending also comes from subsidies and transfers to its 100%-owned Zagrebacki Holding, which along with the capital payments earmarked for debt repayment costs, account 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. Though 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 is 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 by the EU regulations. Thus, to avoid a financial loss in 2017, subsidies for the transport company, including the payment of tram lease costs, increased from the budgeted HRK486 million to HRK647 million.

When adding the indirect exposure, the city's combined net direct and indirect debt (NDID) amounted HRK6.7 billion or 104.4% of operating revenues in 2017 down from HRK7.0 billion or 109.6% of operating revenues in 2016. In 2018, Zagreb's NDID is projected to fall to HRK6.1 billion representing 87% of operating revenues.

The level of guaranteed debt significantly increased to around 35.6% of the city's debt at 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 which was due in July 2017. As such, almost half of the holding company's debt is bearing an unconditional guarantee from the city, confirming recognition of the holding company's debt as the city's obligation.

In December 2017, two branch entities the Zagrebacki Holding owned – Zagrebacki Elektricni Tramvaj (ZET, public transport company) and Zagrebacki Velesajam (trade fair) split off into new limited liability companies. We expect that the demerger will be credit positive for the holding company because it will eliminate the financial pressure stemming from its biggest loss-making branches: ZET and trade fair Zagrebacki Velesajam. Both units' financial performance have been weak.

The demerger is part of the company's restructuring, which aims to divide shared services and market operations. It will allow Zagrebacki Holding to focus its resources on the remaining core entities within the holding company and provide additional cash for debt repayment and investment. The City of Zagreb, as a solely owner of all new companies, will have a control over the management and companies' operations and will continue to provide timely and sufficient support to ZET in form of operating and capital subsidies. Following the demerger, Zagrebacki Holding will benefit from a straightforward reduction of cross-subsidized financial support provided to branch entities in the past years, which will result in additional cost savings.

Weak liquidity position

Despite an overall good financial performance, the city of Zagreb has historically held a limited level of cash reserves. They reached a very low HRK92 million throughout 2017 or 1.4% of operating revenues, down from HRK305 million in 2016.

Nevertheless, the city'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 HRK274 million falling due in 2018.

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 2017). 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

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 baseline credit assessment (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	178.46	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	5.88	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	3	1.19	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	104.37	25%			
Short-term direct debt / total direct debt (%)	3	10.73	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						**2.35(2)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba2**

Source: City of Zagreb, Moody's Investors Service

Ratings

Exhibit 4

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

Source: Moody's Investors Service

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Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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