

## CREDIT OPINION

28 August 2020

 Rate this Research

### RATINGS

#### Zagreb, City of

Domicile	Zagreb, 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.

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## City of Zagreb (Croatia)

### Update to credit analysis

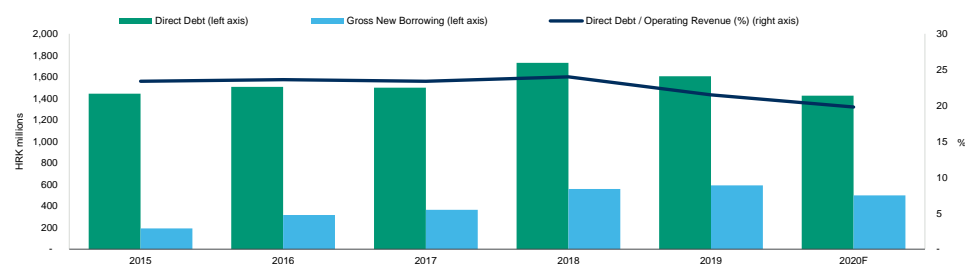
#### Summary

The credit profile of the [City of Zagreb](#) (Ba2 positive) reflects its consistently prudent budgetary management, sound operating margin, low direct debt levels, as well as a moderate likelihood that the [Government of Croatia](#) (Ba2 positive) will provide support if the city were to face acute liquidity stress. The unprecedented shock caused by the coronavirus pandemic and the decline in economic activity will affect the city's revenue in 2020. However, ad hoc financial support from the central government will partially mitigate the negative effect and we expect gradual normalisation by 2021.

Conversely, the rating incorporates the potential pressure stemming from the city's transportation company, [Zagrebacki Elektricni Tramvaj \(ZET\)](#), and the public services provider, [Zagrebacki Holding D.O.O.](#) (Ba2 positive).

#### Exhibit 1

#### Despite the disruption caused by the pandemic, Zagreb's direct debt remains low



F=forecast.

Source: City of Zagreb and Moody's Public Sector Europe

#### Credit strengths

- » Sound operating margin, which will withstand the impact caused by the pandemic shock
- » Central government support, which will mitigate March earthquake's negative effects
- » Overall good financial results, notwithstanding the huge investment requirements
- » Zagreb's wealthy economy and important role as the economic hub of Croatia

#### Credit challenges

- » Debt levels remain high, although declining
- » Limited liquidity

## Rating outlook

The positive outlook on Zagreb's rating mirrors the positive outlook on the sovereign bond rating. It also reflects our expectation that the city will be able to preserve its overall stable financial performance, supported by the central government, which will alleviate the pandemic- and earthquake-driven fiscal pressure in 2020-21. The city's history of prudent budgetary management further supports the positive outlook.

## Factors that could lead to an upgrade

- » Upward pressure on Zagreb's rating could emerge from an upgrade of the sovereign rating, with the maintenance of good financial performance and low direct debt levels.

## Factors that could lead to a downgrade

- » Although unlikely, given the positive outlook, a deterioration in the sovereign credit strength could exert pressure on Zagreb's rating because of the close financial, institutional and operational links between the two tiers of governments.
- » A sustained deterioration in the city's operating performance and a substantial increase in its debt and debt-servicing needs could also lead to a rating downgrade.

## Key indicators

Exhibit 2

### Zagreb, City of Year ending 31 December

	2015	2016	2017	2018	2019	2020F
Net Direct and Indirect Debt/Operating Revenue (%)	112.5	109.6	104.4	70.7	65.1	71.5
Total Direct Debt/Operating Revenue (%)	23.4	23.6	23.4	24.0	21.5	19.8
Cash Financing Surplus (Requirement)/Total Revenue (%)	1.8	-3.9	-5.8	-4.1	-5.9	-5.9
Gross Operating Balance/Operating Revenue (%)	9.5	9.2	3.3	10.7	9.5	8.0
Debt Service/Total Revenue (%)	5.2	5.1	6.8	5.3	7.9	9.8
Capital Expenditure/Total Expenditure (%)	8.6	13.3	10.7	14.9	16.3	16.1
Intergovernmental Transfers/Operating Revenue (%)	2.4	1.6	5.6	2.5	4.6	8.6

F=forecast.

Sources: City of Zagreb and Moody's Public Sector Europe

## Detailed credit considerations

The credit profile of the City of Zagreb, as expressed in its Ba2 positive rating, combines a Baseline Credit Assessment (BCA) of ba2 and a moderate likelihood of extraordinary support from the national government in the event that the entity faces acute liquidity stress.

### Baseline credit assessment

#### Healthy operating margin will withstand the impact of the coronavirus pandemic-induced shock

Zagreb's gross operating balance (GOB) remained healthy at a solid 9.5% in 2019, compared with 10.7% the previous year.

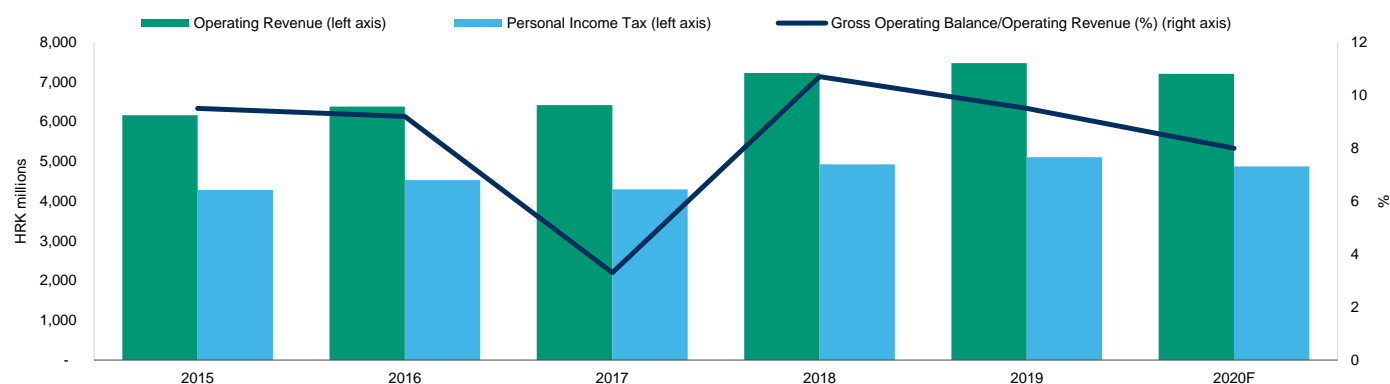
We expect the shared personal income tax (PIT) and surtax on PIT, which together constitute around 70% of the city's operating revenue, to decrease by 7% in 2020, before recovering in 2021 if the pandemic is contained. The expected decline of the proceeds from PIT, estimated at HRK357 million, will mostly be driven by the economic contraction of 9.5%, resulting from the coronavirus pandemic-induced shock (see Exhibit 3). About HRK130 million of the PIT shortfall will result from the changes in the Income Tax Law, effective from 1 January 2020, according to which the nontaxable monthly personal allowance was increased to HRK4,000 from HRK3,000. However, the central government enacted a mechanism to mitigate the negative effect on the local governments, including Zagreb, by allocating HRK129.7 million to the city's budget.

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As a result, GOB for Zagreb will deteriorate, but remain solid at around 7% of operating revenue in 2020. The drop in revenue from income tax will test Zagreb's traditionally prudent budgetary management because of financial rigidity. Own revenue represents a minor proportion of municipal revenue and it accounts for 10% of operating revenue, incorporating property tax, property and administrative fees, which we expect to decrease by 9% in 2020. This high fiscal dependence on state decisions exposes city's finances to the performance of the general government budget and evolving intergovernmental relations.

Exhibit 3

### Economic contraction will lead to lower proceeds from personal income tax



F=forecast.

Source: City of Zagreb and Moody's Public Sector Europe

Zagreb has successfully kept operating spending growth in check through a combination of spending reviews and cost controls over the past several years. Given the rigidity in Zagreb's operating spending, these measures will continue to focus primarily on containing the growth of costs of goods and services, and current transfers and donations. Costs for personnel, goods and services, representing a high 38% of operating spending, along with the subsidies to city's transportation company ZET and donations for social programmes (additional 27% of operating spending), limit the city's spending 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 the local economy from which the city benefits. In 2019, the transfer amounted to HRK800 million (almost 12% of operating expenses).

Although the coronavirus pandemic presents a severe shock for the national economy of Croatia, we expect economic activity to gradually resume in 2021 and the city's revenue to regain its dynamism. We, therefore, expect the city's GOBs to improve, but remain below pre-crisis levels in 2021.

### Central government support will mitigate the negative effect of the earthquake in March

The proactive stance of the central government and self-imposed rescue efforts by the City of Zagreb will significantly reduce the negative credit effects of the earthquake in March that caused billions in damage in the capital city and the surrounding area of Zagreb. A draft law, which is currently in the Parliamentary procedure, will expedite the city's recovery and limit the earthquake's overall negative implications, alleviating the pressure on Zagreb's finances and reducing its borrowing needs.

In accordance with the draft law, the central government will fund 60% of the total recovery costs, while the City of Zagreb and homeowners will each cover 20%. According to preliminary estimates presented in the Ministry of Construction and Physical Planning assessment, the earthquake damages in Zagreb and its surroundings will total about €5.6 billion, or about 10.5% of Croatia's GDP.

The reconstruction will involve a complete renovation of hospitals, schools, cultural monuments and other public buildings up to current earthquake resistance standards, and the government estimates that the renovation costs will total €11.5 billion.

The Croatian government ensured HRK100 million (€13.3 million) was available for emergency repairs by revising the 2020 budget and allocated an additional HRK41 million from the Environmental Protection Fund. Additionally, the Croatian government and the World Bank reached an agreement on a €183.9 million loan and negotiations are underway for a loan from the Council of Europe Development Bank. Croatia will also use part of the €400 million of the Cohesion Policy funds provided as part of the European Union's (EU) Coronavirus Response Investment Initiative to address the impact of the pandemic on the healthcare system, which is already

under strain because of the recent earthquake. As an EU member state, Croatia is entitled to receive financial aid from the EU Solidarity Fund amounting to around €600 million, with additional multilateral assistance likely.

In the latest revision of the budget, the city committed an additional HRK114 million to the earthquake relief fund for emergency repairs. Coordinated national and international humanitarian and financial assistance is likely to expedite the city's recovery, lower the cost of financing for reconstruction and limit a worsening of the city's financing deficit.

#### **Overall good financial results, notwithstanding the huge investment requirements**

In 2019, the city posted a low financing deficit of 5.9% of total revenue compared with 4.1% in 2018. Zagreb will probably resize or postpone some of its initially planned capital investments, estimated at HRK1.043 million in 2020, to prevent the broadening of financing deficits, projected at 6% of total revenue.

Since Croatia joined the EU in 2013, the city and its institutions have implemented projects with a total cost of over HRK2.5 billion from the EU programmes and funds, covering around 35% of total investments. We expect Zagreb to continue making effective use of new funding opportunities offered by the 2014-20 programming period for EU funds, without exerting excessive pressure on its budget. This will diversify its funding sources for capital investment in 2020, with EU funds likely to account for about 30%-35% of the total. A further 40%-45% will come from the city's own operating balance and new borrowings will cover the remaining 25%.

The city will reevaluate its investment priorities following the damages caused by the earthquake. However, the capital spending plan focuses on infrastructure, including public transportation, road maintenance, social service facilities, healthcare, water supply and sewage, energy efficiency measures and solid waste treatment facilities.

#### **Zagreb's wealthy economy and important role as the economic hub of Croatia**

Zagreb is the capital of Croatia and the country's largest city with 805,000 inhabitants (2018 latest available data), representing almost 20% of the national population. As the capital city, Zagreb contributes significantly to the country's economy, accounting for 34% of the national GDP. With local GDP per capita at 175.3% of the national average (data as of 2017), Zagreb is Croatia's wealthiest city. It is the base for almost 33% of Croatia's businesses, which provide 30% of the country's total employment (data as of March 2019). The city's unemployment rate was 3.6% as of year-end 2019, well below the national rate of 6.6%.

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.

#### **Debt levels remain high, although declining, and the pressure stemming from city-owned companies persist**

The city's direct debt increased to HRK2.0 billion, representing a moderate 27% of operating revenue in 2019 compared with 24% 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 2020-21. 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 around 25.5% of projected operating revenue in 2020 before increasing to 28% by 2021.

The structure of Zagreb's debt is relatively simple, with 51% of total direct debt represented by bank loans, an additional 28% made up of commodity loans and the remainder consisting of unconventional debt instruments such as factoring deals.

The city's debt-servicing costs increased to 8% of total revenue in 2019 from 5.3% in 2018, but will remain manageable between 8% and 9% in 2020-21 because of favourable repayment schedules.

The transportation company ZET, which spun off from Zagrebacki Holding in December 2017 and emerged as a limited liability company under the city's direct control, reported a positive financing result for the second consecutive year in 2019 after a long period of generating losses. Notwithstanding the positive financing results, ZET will remain a continuous source of budgetary pressure on the city's budget, given the planned investments, in particular the renewal of its tram and bus fleet, as well as the construction of a cabin lift to Sljeme, estimated at HRK500 million.

The subsidies to ZET rose in 2019 following the adjustments in the way the sector is financed and amounted to HRK672 million up from HRK580 million in 2018 and will continue to rise again in 2020 to HRK739 million. Since 2017, the level of subsidies is based on

a new contract, which requires full compensation for public transportation service obligations as well as a fair level of profit (including depreciation), as required by EU regulations.

When taking into account the guaranteed debt of Zagrebacki Holding, a 100%-city owned utility company, and debt of non-self supporting transportation company ZET, the city's net direct and indirect debt (NDID) accounted for a high 65% of operating revenue as of year-end 2019 (down from 71% in 2018 and 104% in 2017). The latest projections suggest that NDID debt will grow to 72% of operating revenue in 2020, driven by the new debt of the city's owned companies to support planned investments.

#### Limited liquidity

Despite overall good financial performance, the City of Zagreb has historically held a limited level of cash reserves. The city's liquidity deteriorated in 2019, averaging HRK86 million in the year, compared with HRK149 million in 2018.

Nevertheless, Zagreb's regular and predictable inflow and outflow throughout the year and its cash-generating capacity provide sufficient cash to cover the city's debt servicing requirements due in 2020. The city follows a prudent cash management strategy, which, together with regular distributions of shared taxes, ensures smooth cash flow.

While we expect some volatility resulting from the negative effects of the earthquake and pandemic in 2020, we believe the city's liquidity will remain broadly stable.

In addition, the Ministry of Finance, in its efforts to mitigate the coronavirus pandemic-induced shock, introduced interest-free, short-term loans to local governments in Croatia, and the City of Zagreb was provided a loan of HRK73 million in May 2020.

#### 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.

#### ESG considerations

We take account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Zagreb, the materiality of ESG factors to its credit profile is as follows:

Environmental considerations are material to Zagreb's credit profile. Its main environmental risk exposures relate to earthquakes. However, as evidenced during the earthquake in March, the national government bears most of the costs of reconstruction at the local level. The city has only limited exposure to some flood risk, but in that case, the central government would provide support.

Social considerations are material to Zagreb's credit profile. We view the coronavirus pandemic as a social risk under our ESG framework, given the substantial implications for public health and safety. Zagreb is more specifically exposed to the evolution of its demography, with its population exposed to net immigration flows. The unemployment rate in Zagreb is lower than the average for Croatia, and the average salary in Zagreb is higher than that in the remaining parts of the country. These factors have led to immigration to the city recently.

Governance considerations are material to Zagreb's credit profile. Zagreb uses prudent financing planning, which allows for multiyear forecasting of key trends, providing the city with the ability to identify potential pressures and allowing for sufficient time to adjust plans to mitigate any credit implications.

Further details are provided in the "Baseline Credit Assessment" section above. Our approach to environmental, social and governance factors is explained in our cross-sector methodology [General Principles for Assessing Environmental, Social and Governance Risks](#).

## Rating methodology and scorecard factors

The assigned BCA of ba2 is close to the scorecard-indicated BCA of ba3. The matrix-generated BCA of ba3 reflects an Idiosyncratic Risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and a Systemic Risk score of Ba2, as reflected in the sovereign bond rating of Croatia.

For details of our rating approach, please refer to [Regional and Local Governments](#) rating methodology, published on 16 January 2018.

Exhibit 4

### Zagreb, City of Rating factors

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	1	177.04	70%	1	20%	0.20
Economic volatility	1		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	5		50%	4	20%	0.80
Financial flexibility	3		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenues (%)	3	8.94	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	1	0.78	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	65.11	25%			
Short-term direct debt / total direct debt (%)	9	40.69	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						<b>2.58(3)</b>
<b>Systemic Risk Assessment</b>						<b>Ba2</b>
<b>Suggested BCA</b>						<b>ba3</b>

Sources: City of Zagreb and Moody's Public Sector Europe

## Ratings

Exhibit 5

Category	Moody's Rating
<b>ZAGREB, CITY OF</b>	
Outlook	Positive
Issuer Rating	Ba2

Source: Moody's Investors Service

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