MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
27 July 2016

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RATINGS

Zagreb, City of

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

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

Katerina Hanzlova 420-224-106-448
Analyst
katerina.hanzlova@moodys.com

Mauro Crisafulli 39-02-9148-1105
Associate Managing Director
mauro.crisafulli@moodys.com

Zagreb, City of

Croatia

Summary Rating Rationale

The City of Zagreb's Ba2 issuer rating reflects its good operating surpluses, although these are under pressure due to recent changes in income tax law, as well as the Croatian economy's relatively weak medium-term growth prospects. The rating also takes into account the city's manageable direct debt burden, its strong overall fiscal discipline, and its crucial role as the capital city of Croatia.

The rating also reflects the challenges associated with the city's significant indirect debt exposure through its majority-owned company, Zagrebacki Holding (Ba3, negative), its improved but still low liquidity, and its limited revenue control.

Credit Strengths

» Good operating margins.

» Improved financial performance thanks to contained capex plans.

» Increased direct debt remains at manageable levels.

» A crucial role in the national economy.

Credit Challenges

» Significant indirect debt exposure stemming from the city's wholly owned subsidiary, Zagrebacki Holding.

» Improved but still low liquidity.

» Limited revenue control under the current framework.

Rating Outlook

The negative outlook on the city reflects the outlook on Croatia's sovereign rating.

Factors that Could Lead to an Upgrade

Stabilisation of the outlook or an upgrade of Zagreb's rating could result from (1) a similar action on Croatia's sovereign rating, given their close financial and operational linkages; and (2) substantial and sustained improvement of the city's operating surpluses and a reduction of its net direct and indirect debt.

Factors that Could Lead to a Downgrade

A downgrade of Zagreb's rating would result from (1) a downgrade of Croatia's sovereign rating; (2) a material deterioration in the city's operating performance; and/or (3) a further increase in its debt and debt-servicing needs.

Key Indicators

Exhibit 1

Key Indicators

Zagreb, City of

	2011	2012	2013	2014	2015
Net Direct and Indirect Debt/Operating Revenue (%)	112.9	111.6	96.9	109.2	112.5
Total Direct Debt/Operating Revenue (%)	8.4	8.4	7.3	22.5	23.4
Cash Financing Surplus (Requirement)/Total Revenue (%)	-2.1	-0.5	9.2	-14.8	1.8
Gross Operating Balance/Operating Revenue (%)	13.8	14.4	22.1	12.5	9.5
Debt Service/Total Revenue (%)	3.4	3.1	2.6	4.6	5.2
Self-financing Ratio	0.9	1.0	1.6	0.5	1.2
Intergovernmental Transfers/Operating Revenue (%)	1.0	0.7	0.8	1.7	2.4

Source: City of Zagreb

Detailed Rating Considerations

Zagreb's rating combines (1) its baseline credit assessment (BCA); 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

GOOD OPERATING MARGINS

A gradual economic recovery should enable Zagreb's operating margins to return to a solid levels, with an anticipated gross operating balance (GOB) of around 12% of operating revenue in 2016 and beyond. This compares with less than 10% of operating revenue in 2015, and an average of 17% in 2009-2013

Zagreb's operating performance has been adversely affected by Croatia's long recession, as well as changes in its tax law. The city applied austerity measures throughout 2014 and particularly in 2015, which stopped growth in operating expenditure. However, this was not enough to offset a 10% decline in income tax revenues, the city's key revenue source, for two consecutive years. In 2015, Zagreb obtained 70% of its operating revenues from income taxes. The city's second largest source of income is local taxes, fees and charges, which accounted for 26% of operating revenue at year-end 2015.

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

IMPROVED FINANCIAL PERFORMANCE THANKS TO CONTAINED CAPEX PLANS

Zagreb's financial performance is closely tied to its capital spending. The deterioration of the city's operating balance in 2014 came just as capital expenditure reached a five-year peak of HRK1.85 billion, up from HRK1.05 billion on average during 2010-13. This led to a financial deficit of 15% of total revenue. However, a 50% reduction in capital spending compared with initial plans enabled the city to return to financial surplus of almost 2% of total revenue in 2015.

Official projections for 2016-17 indicate contained annual capex of below HRK1.0 billion, which should keep the city's financial performance in positive territory, with only limited recourse to new debt. Moody's believes that Zagreb's administration will continue to be able to match capex with available funding.

INCREASED DIRECT DEBT REMAINS AT MANAGEABLE LEVELS

In 2015 the city's direct debt remained almost unchanged at HRK1.44 billion, having grown to HRK1.49 billion in 2014 from HRK0.5 billion at year-end 2013. The city's direct debt remains manageable at 23.4% of operating revenue in 2015 compared with 7.3% at year-end 2013.

The notable growth in debt in 2014 reflected the city's purchase of Zagrebacki Holding's non-operating properties Gredelj and Zagrepcanka, a transaction designed to support Zagrebacki Holding's financial restructuring. Zagrebacki Holding used the HRK961 million proceeds to service its overdue commercial payables and reduce its debt burden.

Although we regard this debt increase as a credit constraint in light of the city's weakened operating margins, we note that the debt has a long term maturity of 10 years. This makes both the debt and its servicing costs manageable. Zagreb's total debt service exceeded 5% of total revenue in 2015 compared with the previous years' average of around 3%. Debt service is expected to stabilize at the 2015 level in the medium term. The entire direct debt of Zagreb was comprised of bank loans and denominated in local currency.

In 2016-17, we expect the city's direct debt to stabilize close to 20% of operating revenues, given limits on local government borrowing imposed by the central government. In the medium-term, additional funding needs might arise from a requirement to contribute to projects that are funded in part by the European Union (EU). Such projects are not factored into the borrowing limits, although high levels of EU co-financing means they should not put extensive pressure on the city's budget.

A CRUCIAL ROLE IN THE NATIONAL ECONOMY

The City of 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 nation's capital, Zagreb contributes significantly to the national economy, accounting for one third of national GDP. With local GDP per capita at 177% of the national average (2013 latest available data), Zagreb ranks among the wealthiest of Croatian cities. The city is the base for almost 34% of Croatia's businesses, which provide 36% of the country's exports and 29% of total employment (2013 latest available data).

Commerce and industry represent the major drivers of Zagreb's economy, contributing around 42% to local output and absorbing 18% and 11% of the workforce respectively. Zagreb benefits from a diversified industrial base, with food processing, machinery construction, petrochemical and chemical, and light industries all well represented. Zagreb is the seat of the central government and hosts the country's main universities and the headquarters of the largest companies.

SIGNIFICANT INDIRECT DEBT EXPOSURE STEMMING FROM ZAGREBACKI HOLDING

The city's 100%-owned company Zagrebacki Holding plays an active role in providing all core public services to the city. The major businesses operated by the holding are extremely important for the city and require its ongoing support, either in the form of subsidies or a regulatory framework. Payments to the company are among the main drivers of Zagreb's spending, accounting altogether for one quarter of its budget. Operating and capital subsidies to the company reached 11% of total expenditure in 2015. In addition the City of Zagreb subsidises part of Zagrebacki Holding's debt repayment costs, amounting to HRK136 million or 2% of operating revenue in 2015.

Although the city's indirect debt exposure declined to around HRK5.5 billion in 2015 from HRK6.8 billion at year-end 2013, it is still a sizeable burden. Zagreb's indirect debt comprises debt it has guaranteed or unsecured debt incurred by its holding company. The city's combined direct and indirect debt increased to a relatively high 112.5% of operating revenue in 2015 from 109% in 2014 and 97% in 2013. In 2016, Zagreb's direct and indirect debt is expected to fall below 100% of operating revenue, and gradually decline in the medium term, according to recent forecasts.

An ongoing restructuring program at Zagrebacki Holding initiated in the second half of 2013 has thus far resulted in a stable financial position and improved liquidity. This confirms Zagreb's ability to contain financial risks off-balance sheet and limit funding requirements going forward.

IMPROVED BUT STILL LOW LIQUIDITY

The city's average cash position improved in 2015, averaging HRK172 million, compared with HRK94 million in 2013. This is equivalent to a low 2.8% of operating revenue, and covers just 0.7x of the city's debt service requirements of about HRK240 million falling due in 2016.

Notwithstanding the increase in cash reserves, we expect that Zagreb's cash position will remain at low single-digit levels due to persistently challenging macroeconomic conditions and adverse impacts from changes in the financial framework. However, the city's regular and predictable inflows and outflows throughout the year and cash-generating capacity should offset this low liquidity. Zagreb does not maintain emergency lines of credit.

LIMITED REVENUE CONTROL UNDER CURRENT FRAMEWORK

The institutional framework features low financial predictability and stability. Zagreb has very limited control over its revenue base, which consists mainly of shared taxes (personal income tax). Local tax revenues represent a minor proportion of municipal revenue. This high fiscal dependence on state resources exposes municipal finances to the performance of the general government budget and evolving intergovernmental relations.

Partially mitigating this 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. Furthermore, both the active role played by city-owned holding company in containing expenditure pressure and the flexibility offered by the large proportion of capital expenditure within the municipal budget, offer additional scope to balance the budget.

We do not expect that the composition of Zagreb's operating revenue will significantly differ in 2016-17, given that local finances in Croatia depend on decisions of the central government, leaving local governments with only limited leeway with regard 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 negative).

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

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	180.00	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 (%)	1	12.16	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	3	1.27	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	112.70	25%			
Short-term direct debt / total direct debt (%)	3	16.60	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						2.28(2)
Systemic Risk Assessment						Ba2
Suggested BCA						ba2

Source: Moody's Investors Service

Ratings

Exhibit 3

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

Source: Moody's Investors Service

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