

**CREDIT OPINION**

2 September 2024

Update

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**RATINGS**

**Zagreb, City of**

Domicile	Zagreb, Croatia
Long Term Rating	Baa2
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)**

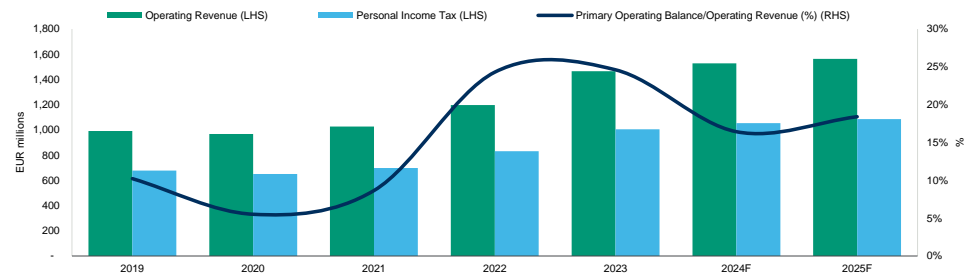
Update following methodology update

**Summary**

The credit profile of the [City of Zagreb](#) (Baa2 positive) reflects its consistently prudent budgetary management, strong operating performance, low direct debt levels as well as a strong likelihood that the [Government of Croatia](#) (Baa2 positive) will provide support if the city were to face acute liquidity stress. Other factors underpinning the credit profile include Zagreb's large and well diversified local economy contributing to a tax revenue base with low volatility and positive growth trend. Conversely, the rating incorporates some limited pressure stemming from the city's public services provider, [Zagrebacki Holding D.O.O.](#) (Baa2 positive) and the city's public transportation company, Zagrebacki Elektricni Tramvaj (ZET)

Exhibit 1

**Improved operating performance in 2022-23 driven by tax revenue growth**



Note: F = Forecast  
Source: City of Zagreb, Moody's Ratings

**Credit strengths**

- » Strong operating performance fueled by growing tax revenues
- » Financing surpluses achieved
- » Zagreb's wealthy economy and important role as the economic hub of Croatia

**Credit challenges**

- » Moderate debt levels, but overall manageable
- » High indirect exposure to city-owned companies
- » Limited liquidity, although improved most recently

## Rating outlook

The positive outlook reflects similar drivers as the outlook on Croatia's rating; namely, strengthened long-term macro-economic growth prospects which should also support Zagreb's financial performance, through growth in shared taxes and government transfers, which represent more than 80% of the city's operating revenue. An improvement in the city's financial performance should also contribute to a continued reduction of its debt burden over the next few years.

## Factors that could lead to an upgrade

An upgrade of Zagreb's rating would require an upgrade of Croatia's sovereign rating as well as continued strong financial performance and moderate debt levels.

## Factors that could lead to a downgrade

Given Zagreb is rated at the same level as the sovereign, a downgrade of the sovereign's rating would also lead to a downgrade of Zagreb's rating. Significant financial deterioration driven by reduced operating margins, an unexpected sharp increase in debt as well as the emergence of liquidity risks, would also exert downward pressure on the city's rating.

## Key indicators

Exhibit 2

### City of Zagreb

City of Zagreb	2019	2020	2021	2022	2023	2024F	2025F
Net Direct and Indirect Debt/Operating Revenue (%)	70.8	109.7	100.4	90.5	78.6	73.9	75.5
Direct Debt/Operating Revenue (%)	27.1	33.2	40.9	33.1	16.0	17.2	22.0
Cash Financing Surplus (Requirement)/Total Revenue (%)	-7.4	-5.1	-7.8	12.5	12.7	-0.9	-2.7
Primary Operating Balance/Operating Revenue (%)	10.2	5.5	8.7	24.3	24.6	16.4	18.4
Debt Service/Total Revenue (%)	8.1	10.0	11.7	19.2	13.1	6.0	6.5
Capital Expenditure/Total Expenditure (%)	16.3	11.8	17.4	13.4	13.5	16.9	20.2
Intergovernmental Transfers/Operating Revenue (%)	4.6	7.9	7.6	8.8	13.3	12.7	12.4

Note: F = Forecast.

Source: City of Zagreb, Moody's Ratings

## Detailed credit considerations

The credit profile of the City of Zagreb, as expressed in its Baa2 stable rating, combines a Baseline Credit Assessment (BCA) of baa2 and a strong likelihood of extraordinary support from the national government in the event that the entity faces acute liquidity stress.

### Baseline credit assessment

#### Improving operating performance fueled by growing tax revenues

In 2023, Zagreb's primary operating performance further improved to 25% of operating revenues, up from very strong 24% of operating revenues a year earlier. This development reflects not only an improvement of economic fundamentals but mainly effective budgetary management and savings measures. The shared personal income tax (PIT) and surtax on PIT, both closely dependent on economic development, are the main revenue source for the city. Zagreb's budgetary management has successfully kept the city's operating spending growth in check through a combination of spending reviews and cost controls.

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2023's real gross domestic product (GDP) growth rate of 3.1% and 2024's expected GDP growth rate of 3.3%, combined with above-national average local economy translates into growing proceeds from the income tax, which will support the city's POB to remain at or above 16% of operating revenue in 2024 and 2025. The shift in the operating margin was achieved through a combination of solid growth of tax revenue and continuation of tight control over the operating expenditures.

The mayor, Mr. Tomislav Tomasevic, elected in May 2021, supported by the majority in the City Council, has successfully introduced a series of cost cutting measures, including such as reduction of personnel cost, subsidiaries and transfers, which were included in the adjusted budget for 2021, as well as in 2022 and 2023 budgets.

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 subsidies. Costs for personnel, goods and services, along with the subsidies to city's transportation company ZET and donations for social programmes (representing more than half of operating spending), still limit the city's spending flexibility.

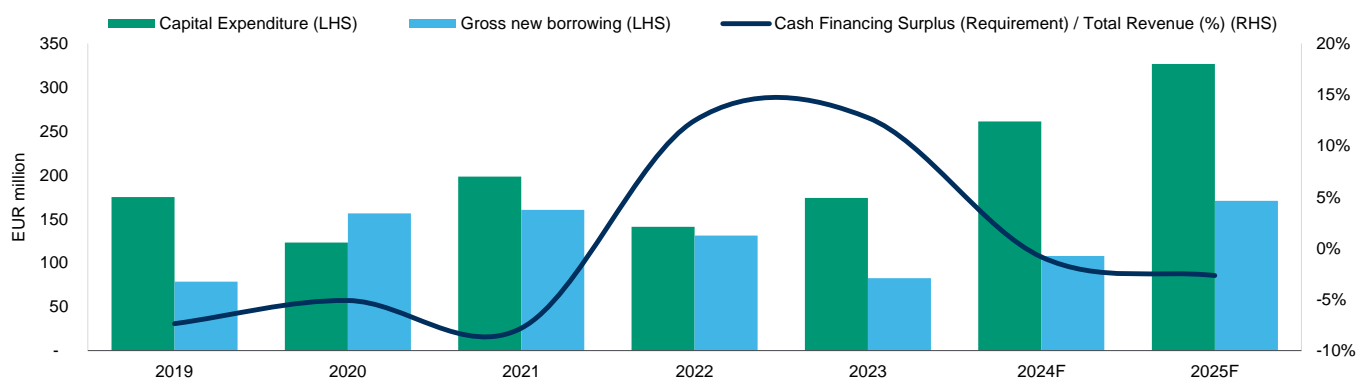
### Financing surpluses achieved

The adjustments of the capital spending has played a significant role in retaining a low financing deficit in 2020-21 as the city posted a deficit of 8% of total revenue in 2021 compared with 5% a year before. From 2022, the city was able to report financial surpluses. We expect only small financial deficits in the following two years (Exhibit 3).

Over the last years, we have seen some downward adjustments of capital expenditures, showing some flexibility, as some projects can be delayed or abandoned if required. However, in 2024 we expect a rise in capital expenditures to around 17% of total expenditures, compared to previous year's 14%.

Exhibit 3

### Improving financing results despite high investment needs



Note: F = Forecast.

Source: City of Zagreb, Moody's Ratings

We expect Zagreb to continue making effective use of new EU funding opportunities offered in the 2021-2027 programming period, without exerting excessive pressure on its budget. This will diversify its funding sources for capital investment in 2024 and following years.

The city's 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. As an EU member state, Croatia and its cities are eligible to several EU investment funding opportunities, including the EU Solidarity Fund, that helped to alleviate the costs for reconstruction in the capital city and the surrounding area of Zagreb, following an earthquake in 2021.

The city of Zagreb is using its access to EU and national financial grants to reduce pressure on its budget and to limit its borrowing needs.

### 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 767,000 inhabitants (2022 latest available data), representing almost 20% of the national population. As the capital city, Zagreb contributes significantly to the country's economy, accounting for almost a third of the national gross domestic product (GDP). With local GDP per capita at around 170% of the national average, Zagreb is Croatia's wealthiest city. It is a home for one third of Croatia's businesses, which provide 32% of the country's total employment (data as of 2020). The city's unemployment rate was 3.1% as of 2022, well below the national rate of 7.6%.

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.

Croatia's adoption of the euro in 2023, in combination with improving institutional effectiveness will also help Zagreb's local economy to improve its growth potential.

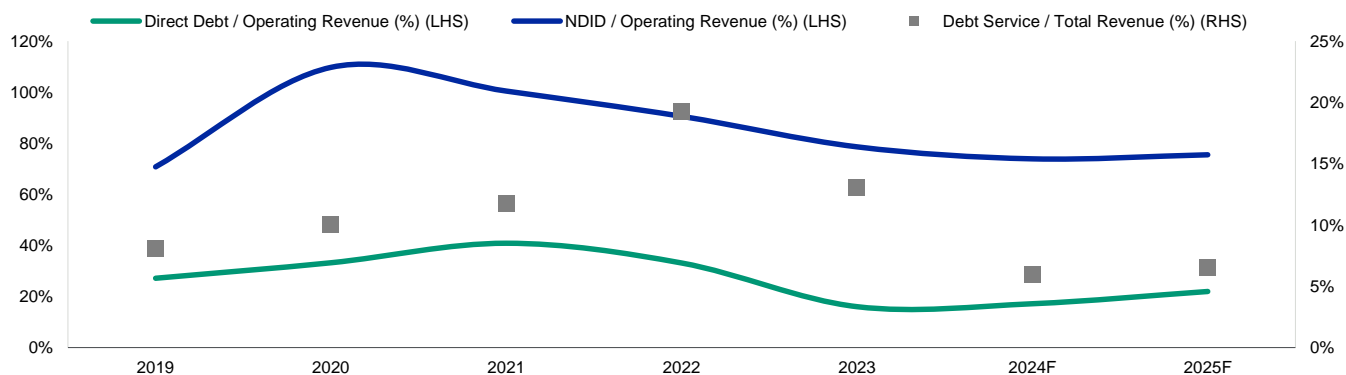
### Moderate debt levels, but overall manageable

The city's direct debt decreased to around €230 million (from nearly €500 million), representing a low 16% of operating revenue in 2023. The decline of city's direct debt was driven by effective budget execution resulting in financial surplus, providing the ability to repay most of its maturing debt.

We expect the city's direct debt burden to remain at comparable levels relative to operating revenues over 2024-25, a result of relatively balanced results expected (Exhibit 4). European Union (EU) and the central government grants for infrastructure will help consolidate Zagreb's financial and debt profile.

Exhibit 4

#### After the pandemic increase debt levels will gradually decline



Note: F = Forecast.

Source: City of Zagreb, Moody's Ratings

The majority of Zagreb's debt is consisted of bank loans with domestic financial institutions, aside of loans with International institutions, including the European Investment Bank, which provide loans for eligible infrastructure investments at favourable conditions. In addition, until 2023 the city benefited from some interest free loans provided by the Ministry of Finance, which have been repaid meanwhile.

The debt service related to Zagreb's direct debt was 13% of total revenue in 2023. down from 19% a year before and will decline to even lower levels over 2024-25. We consider these obligations as manageable given the city's strong operating margins.

**High indirect exposure to city-owned companies**

When accounting for indirect debt, the city's net direct and indirect debt (NDID) is expected to decline to 74% of operating revenue in 2024, and to stay in line with this projection going forward.

Zagreb's indirect exposure is mainly represented by some city-guaranteed debt of Zagrebacki Holding as well as the outstanding debt of the city transportation company ZET, both considered to be non-self supporting companies. The major businesses operated by the holding company and ZET are extremely important for the city and require its ongoing support, either in the form of operating or capital subsidies. Payments to these companies are among the main drivers of Zagreb's spending, accounting for about 15% of its budget.

The city's high indirect debt exposure is largely related to past years' challenging operating and financial environment for the Holding company, reporting several year's of deficits. With holding's financial turnaround to surplus and stabilizing or declining debt trend, the level of guaranteed debt is expected to decrease slightly over the coming years.

Notwithstanding the positive trend, 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, requiring subsidies from the city budget. Since January 2018, when ZET spun off from Zagrebacki Holding and emerged as a limited liability company under the city's direct control, 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).

The high companies' debt levels were also driven by investment projects in the utility and urban transport sectors that were financed through debt issued by Zagrebacki Holding and ZET. In 2022, the Holding and its subsidiaries had total investments of €30 million. ZET's investment programme in 2022 amounts to €11.5 million, mostly for purchasing of new buses and trams and associated transport infrastructure will be secured from the EU funds, with the remainder to be funded from the city's budget and own revenues.

**Limited liquidity, although improved most recently**

In the past, the City of Zagreb has historically held a limited level of cash reserves. The city's liquidity however improved in particular over 2022 and 2023, while a part was used to repay maturing debt in late 2023. We believe the city will properly manage its liquidity, while some surplus liquidity will also be used to repay part of maturing debt.

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. The city follows a prudent cash management strategy, which, together with regular distributions of shared taxes, ensures smooth cash flow.

**Extraordinary support considerations**

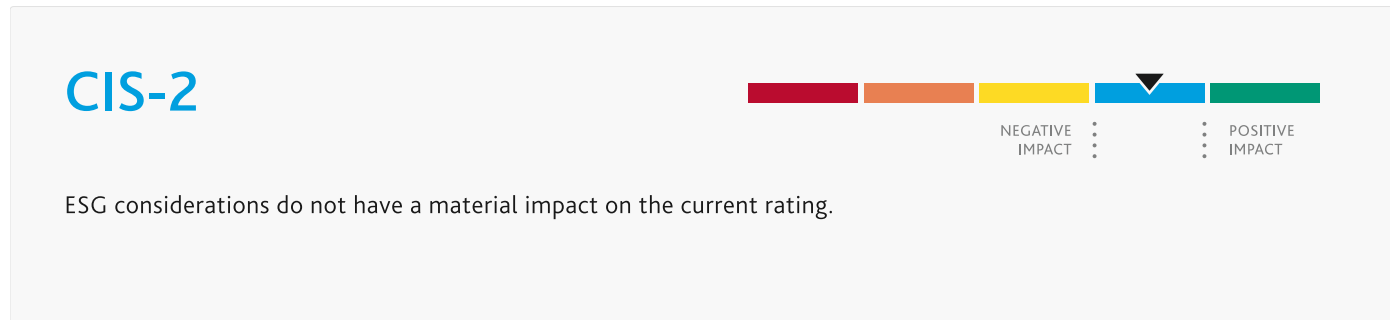
We consider Zagreb to have a strong likelihood of extraordinary support from the national government, reflecting our assessment of the city's strategic importance to the national economy. The system of oversight implemented by the national government requires regular monitoring of cities' financial performance and indebtedness.

## ESG considerations

### Zagreb, City of's ESG credit impact score is CIS-2

Exhibit 5

#### ESG credit impact score



Source: Moody's Ratings

Zagreb's ESG Credit Impact Score (**CIS-2**) reflects the limited impacts of ESG risks on its rating. Although it does face some environmental risks, including physical climate risk, particularly flood risk, these are mostly offset by the city's strong institutions and governance which has acted to improve flood protection.

Exhibit 6

#### ESG issuer profile scores



Source: Moody's Ratings

### Environmental

Regarding the city's exposure to environmental risks (**E-3**), in addition to its moderate exposure to physical climate risk, the city is also responsible for water management and must fund the reconstruction of its sewerage system to improve the collection of water and storm water as well as wastewater.

### Social

Zagreb has limited exposure to social risks (**S-2**). Zagreb benefits from a strong demographic profile, as is more 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. Access to education, healthcare facilities and provision of basic services are good. Zagreb has limited exposure to social risks (**S-2**). It benefits from a strong demographic profile. 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. Access to education, healthcare facilities and provision of basic services are good.

### Governance

Zagreb has solid institutions and governance strength (**G-2**). This is underpinned by the city's high credibility in managing its operations and development by using prudent financing planning, which allows for multiyear forecasting of key trends. Zagreb has an ability to identify potential pressures, allowing for sufficient time to adopt mitigation measures.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click [here](#) to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

## Rating methodology and scorecard factors

The assigned BCA of baa2 is in line with the BCA scorecard-indicated outcome.

For details about our rating approach, please refer to [Rating Methodology: Regional and Local Governments](#), published on 28 May 2024.

Exhibit 7

### Zagreb, City of Regional & Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Score	Factor Weighting	Total
<b>Factor 1: Economy</b>					<b>25%</b>	<b>0.59</b>
Regional Income [1]	0.95	78825.90	15%	0.14		
Economic Growth	6.00	a	5%	0.30		
Economic Diversification	3.00	aa	5%	0.15		
<b>Factor 2: Institutional Framework and Governance</b>					<b>30%</b>	<b>1.35</b>
Institutional Framework	6.00	a	15%	0.90		
Governance	3.00	aa	15%	0.45		
<b>Factor 3: Financial Performance</b>					<b>20%</b>	<b>1.45</b>
Operating Margin [2]	1.67	24.61%	10%	0.17		
Liquidity Ratio [3]	19.70	0.40%	5%	0.99		
Ease of Access to Funding	6.00	a	5%	0.30		
<b>Factor 4: Leverage</b>					<b>25%</b>	<b>0.99</b>
Debt Burden [4]	5.62	78.59%	15%	0.84		
Interest Burden [5]	1.49	0.50%	10%	0.15		
<b>Preliminary BCA Scorecard-Indicated Outcome (SIO)</b>						<b>(4.39) aa3</b>
<b>Idiosyncratic Notching</b>						<b>0.0</b>
<b>Preliminary BCA SIO After Idiosyncratic Notching</b>						<b>(4.39) aa3</b>
<b>Sovereign Rating Threshold</b>						<b>Baa2</b>
<b>Operating Environment Notching</b>						<b>0.0</b>
<b>BCA Scorecard-Indicated Outcome</b>						<b>(9.00) baa2</b>
<b>Assigned BCA</b>						<b>baa2</b>

[1] Regional GDP per capita in terms of purchasing power parity (PPP) terms, in international dollars

[2] Primary Operating Balance / Operating Revenue

[3] Cash and Cash Equivalents / Operating Revenue

[4] Net Direct and Indirect Debt / Operating Revenue

[5] Interest Payments / Operating Revenue

Source: Moody's Ratings; Fiscal 2023.

## Ratings

Exhibit 8

Category	Moody's Rating
<b>ZAGREB, CITY OF</b>	
Outlook	Positive
Baseline Credit Assessment	baa2
Issuer Rating	Baa2

Source: Moody's Ratings

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