S&P Global Ratings

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Research Update:

Croatian City of Zagreb Upgraded To 'BBB+' On Improved Liquidity; Outlook Positive

September 20, 2024

Overview

- Zagreb's liquidity position has substantially strengthened, with liquid reserves well in excess of the city's annual debt service requirements.
- The city's resilient economy underpins tax revenue growth while ample EU funds limit the use of debt for the city's ambitious investment agenda.
- We therefore raised our long-term rating on Zagreb to 'BBB+' from 'BBB-'.
- The outlook is positive, reflecting our view that Zagreb's creditworthiness could strengthen further if prudent financial management practices are firmly embedded, or if financial metrics improve significantly more than we currently project.

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Rating Action

On Sept. 20, 2024, S&P Global Ratings raised its long-term foreign and local currency issuer credit ratings on the Croatian capital city of Zagreb to 'BBB+' from 'BBB-'. The outlook on the rating is positive.

Outlook

The positive outlook reflects our view that Zagreb's creditworthiness could improve further if financial management practices are strengthened, or if the city's budgetary performance metrics consistently outperform our projections, with declining debt-to-consolidated operating revenue.

Upside scenario

We could raise the ratings on Zagreb within the next 24 months if we observed that the ongoing improvements in financial management practices are further entrenched, for example in governance of government-related entities (GREs). Stronger-than—expected budgetary performance and pronounced deleveraging could also lead to an upgrade.

Downside scenario

We would revise the outlook to stable if Zagreb's economy builds up substantial imbalances and economic growth falters, or the city's management fails to sustain improvements in liquidity and debt management, or if budgetary performance deteriorates substantially.

Rationale

The upgrade reflects our assessment that Zagreb's liquidity position has significantly improved. The city now has substantial funds in cash and deposits, well in excess of its annual debt service requirements. We have observed a continual increase in Zagreb's available cash holdings in the past few years, which we view as substantially more prudent than the constrained liquidity situation a few years ago. We understand that the city could use part of the funds--currently in excess of €250 million--for capital spending, and that it intends to maintain a prudent liquid reserve.

Our ratings also reflect Zagreb's expanding economy and continued integration and convergence with the EU. We think that the gradual alignment with EU standards over recent years has contributed, for example, to lower use of off-balance sheet debt for funding and stronger oversight, not least given the strong push for EU-funded investments.

We also expect the city to achieve strong budgetary performance. Zagreb has a moderately high tax-supported debt level that includes the debt of Zagrebacki Holding (ZGH) and public transport company Zagrebacki Elektricni Tramvaj (ZET). We expect the city's debt dynamics to be shaped by the evolution of its public investment program, as borrowing will mainly reflect co-funding projects supported by ample EU funds. The city also has comparably limited budgetary flexibility and a relatively short track record in some areas of financial management, for example, effective governance of the city's GREs and liquidity management.

The robust economy and the improving institutional framework support Zagreb's credit profile

We have noted strengthening in Croatia's local government fiscal framework, which we reflected by revising upward our assessment of the institutional framework assessment for Croatian municipalities ahead of our previous review. The alignment with EU standards has, over time, strengthened the oversight of municipal finances and supported, for example, a reduction in recourse to off-balance sheet funding operations. Coupled with a strong push for EU-funded investments and the requirements attached, this will strengthen transparency and accountability standards for local governments.

At the same time, frequent changes to the intergovernmental framework still hamper predictability for local governments. Under the tax reform that became effective in January 2024, each city can determine its own personal income tax (PIT) rate within certain ranges. Zagreb has opted to set the new PIT rate at the maximum level (35.4% for the higher rate) to mitigate potential revenue losses. The central government has recently presented plans to introduce a property tax, effectively transforming the existing holiday homes tax. We understand that this could bolster Zagreb's tax revenues and would likely be an important policy tool for the city's housing market, a key political topic.

Robust economic performance has further bolstered Zagreb's tax revenue growth in the first half of 2024, and we expect this to continue. Growth in PIT receipts was particularly strong and outweighed the adverse impact from the tax reform. We project the city's economy will continue to expand in tandem with the robust growth that we project for Croatia (2%-3% over 2024-2027).

Zagreb is Croatia's capital and its dominant economic center. The city contributes over one third of Croatia's GDP, and its economic structure is more diversified compared with the national economy, where tourism is dominant, with Zagreb's GDP per capita well above the national average.

Zagreb's current administration, in office since 2021, has made significant strides to improve the city's financial management practices. For example, liquidity levels and liquidity management have substantially improved and the management of key municipal enterprises was changed, with the aim of improving oversight and reducing risk. Fiscal prudence remains a goal, but this might be tested as the May 2025 local elections draw closer, given significant cost and salary increases, and substantial investment needs. We note positively the successful efforts to settle liabilities between city companies and the intention to end past quasi-debt practices, but the track record is relatively short and it remains to be seen if improvements are sustained through political cycles. Given the dependence on decisions made at the national level for Zagreb's finances, good relations with the central government remain crucial for the city, especially if party affiliations of the administration are different, as is currently the case. However, we understand that there has been no major friction recently, for example, around this year's parliamentary elections.

In recent years, the central government provided support to address the pandemic and the energy crisis, and is supporting earthquake reconstruction in Zagreb. Another important source of financial support for the latter has been the EU, through the European Solidarity Fund. The city has access to favorable funding from European promotional banks to finance EU-funded projects, thus supporting its investment agenda.

Zagreb's investment agenda is ambitious but EU funds and favorable funding will limit the recourse to debt

Zagreb's liquidity position has improved significantly compared to previous years. Cash on hand increased to €166.5 million on average in August 2024 from €96.1 million the previous year (and compared to only €14 million in August 2022), substantially raising the coverage of the next 12 months' debt service and financing needs. We think cash balances might slightly fall from next year, depending on the timing of loan drawings and investment project implementation, but will stay at almost €200 million in 2025-2026 as we understand the city is likely to maintain a liquidity buffer. The city reduced payables outstanding in 2023 to a negligible amount, which improved the visibility with respect to liquidity needs. We view Zagreb's access to external liquidity as satisfactory because the city has access to a pool of international banks willing to provide loans, while the eurozone accession has further improved Zagreb's capital market access.

The liquidity position benefits from the city's solid budgetary performance. In 2024, we expect Zagreb to outperform its own budgetary plans as well as our previous projections. This is because tax revenue growth has been particularly robust at more than 15% in the first half of the year, reflecting rising employment and salaries in the city. While we expect strong tax revenue growth to continue in the next two-to-three years, we believe that operating expenditures will also rise due to higher material costs, personnel expenditure, and subsidies for items such as public transport, leading to a slight moderation of operating budget surpluses through 2026.

We project that Zagreb will continue to post strong operating results over 2024-2026, with an average operating budget surplus of 15% of operating revenue. At the same time, we project sizable investment spending will lead to deficits after capital accounts from next year, but this will depend on the pace of the project execution. We understand that the investment spending is tied to EU-funded projects and corresponding financing from European promotional banks, for example a recent €207 million loan from the European Investment Bank.

We continue to view Zagreb's budgetary flexibility as limited because large parts of the revenue structure depend on the central government's decisions. Under the reformed income tax system as of 2024, the city has set the highest rates permissible under the new system to protect its revenue, with no flexibility to adjust the rate upwards. Further flexibility is therefore currently limited to certain municipal fees and taxes, which account for less than 20% of the city's income, but the planned property tax introduction could grant additional revenue flexibility to Zagreb. Spending flexibility is also constrained by subsidies granted to municipal companies ZGH and ZET, both of which supply essential public services. ZGH is responsible for gas distribution and supply; water supply and sewerage; road maintenance; waste disposal; and real estate projects. We do not think asset sales will provide additional room to maneuver in the near term.

Zagreb has a sizable public investment strategy, addressing substantial investment needs in various areas. These, for example, concern public buildings, education, public transport, recreational facilities, housing and, importantly, wastewater treatment. In many of these areas, EU funds will cover a substantial part of the expenditure. Therefore, we expect that the city's tax-supported debt increase will be contained, to 64% of operating revenue in 2026 from 58% in 2024. That said, we note that the debt ratio could be lower than our current projection if investments are executed more slowly than planned.

We include the debt of ZGH and ZET in our tax-supported debt ratio, which includes the debt of various municipal companies and nontraditional debt, like factoring. We understand that the city has for the most part already ceased past off-budget financing practices and supports ZGH's further deleveraging.

Direct debt comprises less than a quarter of the city's tax-supported debt, given the past use of nontraditional means like factoring and substantial borrowing by municipal companies. Direct debt consists of loans from domestic banks for investment projects and small amounts of short-term debt, but we think that direct debt will increase as the city is preparing to borrow from European promotional banks to finance its investment agenda.

We regard the city's contingent liabilities as low overall, given that the debt of ZGH and ZET is already included in the tax-supported debt calculation. Contingent liabilities include spending on earthquake-related repairs to private buildings with low yearly drawings, liabilities of other GREs apart from ZGH and ZET, and some litigation risks. By law, Zagreb needs to cover 20% of the costs of rebuilding the more heavily damaged private buildings. The costs are hard to estimate, but effective drawings on Zagreb's finances were well below budgeted funds so far, which we believe is likely to continue. In our view, the city might support ZGH and ZET by taking on additional payables from the companies or by injecting capital.

Key Statistics

Table 1

Zagreb--Selected Indicators

	--Fiscal year-end Dec. 31--					
Mil. €	**2021**	**2022**	**2023**	**2024bc**	**2025bc**	**2026bc**
Operating revenues	1,019	1,198	1,329	1,576	1,567	1,611

Table 1

Zagreb--Selected Indicators (cont.)

	--Fiscal year-end Dec. 31--					
Mil. €	**2021**	**2022**	**2023**	**2024bc**	**2025bc**	**2026bc**
Operating expenditures	938	1,020	1,104	1,244	1,358	1,441
Operating balance	81	178	225	332	209	170
Operating balance (% of operating revenues)	8.0	14.8	16.9	21.1	13.3	10.6
Capital revenues	41	8	187	183	145	58
Capital expenditures	205	158	197	330	436	281
Balance after capital accounts	(82)	28	215	185	(82)	(53)
Balance after capital accounts (% of total revenues)	(7.7)	2.3	14.2	10.5	(4.8)	(3.2)
Debt repaid	110	220	170	60	95	104
Gross borrowings	185	130	83	47	130	157
Balance after borrowings	(6)	(62)	128	172	(47)	0
Direct debt (outstanding at year-end)	411	323	235	222	257	310
Direct debt (% of operating revenues)	40.3	27.0	17.7	14.1	16.4	19.2
Tax-supported debt (outstanding at year-end)	1,364	1,285	1,124	1,138	1,200	1,282
Tax-supported debt (% of consolidated operating revenues)	103.3	82.7	65.8	57.9	61.2	63.6
Interest (% of operating revenues)	0.6	0.5	0.4	0.5	0.6	0.6
Local GDP per capita (single units)	25,419	29,686	33,224	35,247	37,047	38,845
National GDP per capita (single units)	15,184	17,733	19,846	21,055	22,130	23,204

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. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Zagreb--Ratings score snapshot

Key rating factors	Scores
Institutional framework	4
Economy	3
Financial management	4
Budgetary performance	3
Liquidity	1
Debt burden	3
Stand-alone credit profile	bbb+

Table 2

Zagreb--Ratings score snapshot (cont.)

Key rating factors	Scores
Issuer credit rating	BBB+

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 our "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 Upgraded To 'A-' On Reform Progress; Outlook Positive, Sept. 13, 2024

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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

- Global Ratings List: International Public Finance Entities July 2024, July 30, 2024
- Sovereign Risk Indicators, July 8, 2024. Interactive version available at http://www.spratings.com/sri
- Local And Regional Governments Outlook Midyear 2024: Persistent Spending Needs Are Leading To Growth In Debt Burdens, June 27, 2024
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., June 18, 2024
- Croatian Municipalities' Transparency Benefits From Eurozone Accession, March 25, 2024
- Subnational Debt 2024: Focus on debt sustainability, Feb. 29, 2024
- Subnational Debt 2024: Chinese Governments Reach Their Limits; Other Emerging Markets Taper Borrowing, Feb. 29, 2024

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

Upgraded

	To	From
Zagreb (City of)		
Issuer Credit Rating	BBB+/Positive/--	BBB-/Positive/--