Research Update:

Croatian City of Zagreb Upgraded To 'BB+' On Improving Liquidity; Outlook Positive

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Overview

- The city of Zagreb has substantially strengthened its liquidity holdings and we expect its liquidity position to continue to strengthen structurally.
- At the same time, resilient economic growth continues to underpin Zagreb's budgetary performance and we believe the institutional setting for Croatian local governments is improving.
- We therefore raised our rating on Zagreb to 'BB+' from 'BB'.
- The outlook is positive, reflecting our expectation that Zagreb's credit profile could strengthen if the institutional framework for Croatian municipalities became more predictable over the next one to two years, Zagreb's economy continued to expand, and the city sustained its liquidity improvements.

Rating Action

On Sept. 22, 2023, S&P Global Ratings raised its long-term foreign and local currency issuer credit ratings on the Croatian capital city of Zagreb to 'BB+' from 'BB'. The outlook on the rating is positive.

Outlook

The positive outlook reflects our expectation that continued economic growth, an improved institutional framework for Croatian local governments, and improving funding access in the wake of eurozone accession could further strenghten Zagreb's credit profile.

Upside scenario

We could raise the rating on Zagreb over the next 12 months if the improvement of the city's liquidity position is sustained, leading to further structural improvements beyond 100% debt service coverage with liquid funds; and if Croatia's and the city's income levels in terms of GDP continue to rise. An improvement in the predictability of the institutional framework governing Croatian muncipalities, by itself or coupled with city-specific improvements, could also lead to a positive rating action.

Downside scenario

We could revise the outlook to stable if Croatia's and Zagreb's economic growth falter and budgetary performance deteriorates substantially, or if liquidity improvements are not sustained. A reversal of the improving institutional framework trend would also prompt a stable outlook, for example if the sector's aggregate finances are adversely affected by government reform efforts.

Rationale

The upgrade reflects Zagreb's improved liquidity situation compared with previous years, with average monthly cash reaching €92 million in July 2023. At the same time, Croatia's and Zagreb's economies continue to demonstrate resilient growth despite a subdued macroeconomic environment in Europe. This will likely translate into robust tax revenue growth and therefore help the city preserve a sound budgetary performance, even in the wake of inflation-driven cost increases and elevated capital expenditure needs. At the same time, the fiscal framework for Croatian municipalities is improving, as efforts to improve the sector's revenue and expenditure balance as well as transparency and planning standards are taking hold.

Our ratings on Zagreb also take into account its moderately-high tax-supported debt burden including the debt of Zagrebacki Holding and public transport company ZET. The city also has comparably limited budgetary flexibility and a weak track record in some areas of financial management, for example regarding the city's government-related entities (GREs) and liquidity management, with recent improvements still to be firmly embedded. On the other hand, we view positively central government and EU funds supporting investment spending and the remaining reconstruction after the 2020 earthquakes.

Robust economic growth and progress on institutional settings support Zagreb's credit profile

Zagreb is Croatia's capital and dominant economic center. The city contributes over one-third of Croatia's GDP, and its economic structure is diversified compared with the national economy where tourism is dominant. Zagreb has a stronger socioeconomic profile than the national average, with an unemployment rate of 3.1% in 2022 compared with 7.6% for Croatia, and GDP per capita exceeding the national average by 75% (2020 data). Over the past decade, Zagreb's population decreased at a much lower rate than Croatia's, reflecting the attractiveness of the city's labor market. We expect a broadly stable population trend going forward.

We project the city's economy will expand in tandem with the resilient growth that we project for Croatia. Our projections for Croatia factor in growth of 2%-3% over 2023-2026. This reflects continued dynamism of the tourism sector and benefits from the 2023 eurozone accession, as well as substantial EU-funded investments. Croatia is among the top EU countries in terms of implementation of the Recovery and Resilience Facility (RRF) and Zagreb is benefitting from these and other EU funds as well. The robust macroeconomic environment underpins our projection of sound tax revenue growth for Zagreb.

That said, we view some elements of the tax-sharing and institutional framework for Croatian municipalities as rather volatile. The policy environment could become increasingly contentious between government tiers as elections draw closer--national elections in 2024 and municipal in 2025. From 2024, the central government will raise the basic exemption and replace the city surtax with a system where municipalities decide on personal income tax rates within certain boundaries. For the city of Zagreb, this in isolation will likely have a negative revenue impact. We still assess the predictability of the intergovernmental setting as somewhat reduced, given relatively frequent tax code changes that complicate longer-term planning. That said, we note improvements, with efforts to improve local governments' fiscal balance yielding results and we anticipate that eurozone accession will serve as a further institutional anchor in various areas. We hence see the institutional framework as on an improving trend.

The city's administration under Mayor Tomasevic, in office since 2021, has made significant strides to improve the city's financial management practices, for example regarding the transparency of the budgetary process. Liquidity levels and liquidity management have substantially improved and the control over key municipal enterprises has been reshuffled, with the aim of improving oversight and reducing risk. Fiscal prudence remains a goal, but this might be tested, given significant cost and salary increases. We note positively the ongoing efforts to settle liabilities between city companies and the intention to end past quasi-debt practices, but the past track record still weighs on our assessment until improvements are fully institutionalized. 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.

We expect that elevated investment needs will continue to weigh on Zagreb's budgetary performance. At the same time, we anticipate that the city would access favorable funding from European promotional banks to finance EU-funded projects, thus supporting its investment agenda.

The liquidity position continues to strengthen amid sound budgetary performance

We expect Zagreb's budgetary performance will remain robust, with an average operating surplus of about 15% of operating revenue over 2023-2025, thanks to strong tax revenue growth. At the same time, we expect the balance after capital accounts to gradually turn to a small deficit by 2025.

The city had access to the EU Solidarity Fund until midyear 2023 to alleviate the cost of rebuilding infrastructure after two earthquakes in March 2020 and withdrew about €200 million by that deadline. The unfinished remaining work will be financed by the central government and some eligible parts by RRF funds.

Zagreb's budgetary flexibility is limited because large parts of the revenue structure ultimately depend on the central government's decisions. The legislative framework also limits the borrowing capacity of the city, curbing flexibility on financing investments. We have also observed constraints on the willingness to increase revenues in some areas, such as fees. However, under the reformed income tax system, the city can set the PIT rate within certain boundaries. Expenditure flexibility is constrained by subsidies granted to municipal companies Zagrebacki Holding (ZGH) and Zagrebacki Elektricni Tramvaj (ZET), both of which supply essential public services. Asset sales have been difficult to achieve in recent years and do not provide additional room to maneuver in the near term.

We project a moderate debt increase over 2024-2025 as we understand that the city intends to limit its debt intake to loans for EU-funded projects and those that are key for the city's agenda, such as energy efficiency. We project that the city will take on relatively low amounts of short-term debt. In our projection, tax-supported debt will increase to almost 90% of operating revenues by 2026 from 83% in 2022, which we regard as high for a local government in Central and Eastern Europe. The lion's share of the increase reflects moderate net new borrowing for investment projects. Direct debt is less than half the city's tax-supported debt, reflecting the substantial use of nontraditional means like factoring and the debt of various municipal companies. We therefore include the debt of ZGH and ZET in our tax-supported debt ratio. We understand that the city intends to end past off-budget financing practices and support ZGH's deleveraging. We assume Zagreb will continue to reduce payables and aims to sustain its increased cash holdings compared with previous years.

We regard contingent liabilities as low overall. These consist of spending for earthquake-related damages on 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, effectively limiting the city's contingent liabilities relating to earthquake-related damage. In our view, the city might support ZGH and ZET by taking on additional payables from the companies or by injecting capital. Foreign exchange risk is very limited following the adoption of the euro, because all debt is in euros.

In our view, Zagreb's liquidity situation has improved significantly. Cash on hand increased to €92 million on average in July 2023, substantially raising the coverage of the next 12 months' debt service and financing needs. The city reduced payables outstanding in 2022, which helped further ease stress on liquidity. We view Zagreb's access to external liquidity as satisfactory because the city has access to a pool of international banks willing to provide short-term loans and because eurozone accession should facilitate Zagreb's capital market access.

Key Statistics

Table 1

Zagreb (City of) Selected Indicators

	--Year ended Dec. 31--					
	2020	2021	2022	2023bc	2024bc	2025bc
Operating revenues	949	1,019	1,198	1,262	1,298	1,326
Operating expenditures	909	938	1,020	1,041	1,100	1,150
Operating balance	41	81	178	221	197	176
Operating balance (% of operating revenues)	4.3	8.0	14.8	17.5	15.2	13.3
Capital revenues	24	41	8	27	9	9
Capital expenditures	104	205	158	209	206	218
Balance after capital accounts	(40)	(82)	28	39	1	(32)
Balance after capital accounts (% of total revenues)	(4.1)	(7.7)	2.3	3.1	0.1	(2.4)
Debt repaid	105	110	220	138	84	72
Gross borrowings	177	185	130	150	130	104
Balance after borrowings	32	(6)	(62)	52	47	0

Table 1

Zagreb (City of) Selected Indicators (cont.)

	--Year ended Dec. 31--					
	2020	2021	2022	2023bc	2024bc	2025bc
Direct debt (outstanding at year-end)	339	411	323	335	381	413
Direct debt (% of operating revenues)	35.7	40.3	27.0	26.5	29.4	31.2
Tax-supported debt (outstanding at year-end)	1,315	1,364	1,285	1,400	1,481	1,533
Tax-supported debt (% of consolidated operating revenues)	96.4	103.3	82.7	85.2	87.5	88.5
Interest (% of operating revenues)	0.6	0.6	0.5	0.7	0.6	0.6
Local GDP per capita (single units)	21,829	22,783	26,180	28,271	29,642	31,200
National GDP per capita (single units)	12,466	14,990	17,369	18,770	19,777	20,727

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 (City of) Ratings Score Snapshot

Key rating factors	
Institutional framework	5
Economy	3
Financial management	4
Budgetary perfomance	3
Liquidity	3
Debt burden	3
Stand-alone credit profile	bb+
Issuer credit rating	BB+

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 the "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 Outlook Revised To Positive On Macroeconomic And Fiscal Resilience; 'BBB+/A-2' Ratings Affirmed, Sept. 15, 2023

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

- Sovereign Risk Indicators, July 10, 2023
- Russia-Ukraine Military Conflict: Key Takeaways From Our Articles, June 29, 2023
- Economic Outlook Eurozone Q3 2023: Short-Term Pain, Medium-Term Gain, June 26, 2023
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Comparative Statistics: Local And Regional Government Risk Indicators: European LRGs Stay Firm Amid Economic Slowdown And High Inflation, Sept. 22, 2022

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	BB+/Positive/--	BB/Positive/--