FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Polish City of Katowice at 'A-'; Outlook Stable

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Fitch Ratings - Warsaw - 28 May 2021: Fitch Ratings has affirmed the Polish City of Katowice's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'A-' and National Long-Term Rating at 'AA+(pol)'. The Outlooks are Stable. A full list of rating actions is below.

Feedback

The affirmation reflects Fitch's unchanged view that Katowice's operating performance and debt ratios will remain in line with 'A-' rated peers' over the medium term, despite the economic downturn triggered by the coronavirus pandemic and persistent pressure on current and capital spending. The city's Standalone Credit Profile (SCP) is assessed at 'a-'. Katowice's IDRs are equal to, but not capped by, the sovereign ratings (A-/Stable).

Katowice is a medium-sized city with a population of close to 300,000 located in the Slaskie region and the region's capital. The local economy, in terms of gross value added in 2018, is dominated by services. It's unemployment rate of 1.7% at end-2020 (2019: 1.0%) was one of the lowest among Polish cities (6.2% national average). The city's average salary at end-2019 was PLN6,176, 19% higher than the national average.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Katowice's 'Midrange' risk profile reflects a combined assessment of four key factors at 'Midrange' (revenue robustness, expenditure sustainability and liabilities, and liquidity flexibility and robustness), one 'Stronger' (expenditure adjustability) and one 'Weaker' (revenue adjustability).

The assessment reflects Fitch's view of a reasonably low risk that Katowice's debt service coverage by the operating balance will weaken unexpectedly over the forecast horizon (2021-2025), either because of revenue falling short of expectations or spending exceeding expectations, or an unanticipated rise in liabilities/debt-service requirements.

Revenue Robustness: 'Midrange'

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The city has a proven record of operating revenue growth, with a CAGR of 6.3% in 2016-2020, underpinned by higher GDP per capita and low unemployment. Operating revenue is mostly made up of taxes and fees (54% of operating revenue in 2020), such as personal income tax (PIT; 28%) as well as local taxes (mainly property tax) and fees (together 21%).

Corporate income tax (CIT), which is the most volatile revenue item and represented 5% in operating revenue in 2020, unexpectedly rose 8.6% yoy or PLN8.5 million. This, together with the property tax - which increased 1.8% or PLN4.3 million -

however was not sufficient to compensate the PIT revenue fall of 4% or PLN24.1 million. The latter was affected more by the central government's decisions to cut PIT rates and exempt people under the age of 26 from PIT than by the pandemic.

Current transfers accounted for 37% of operating revenue in 2020, up from 35% in 2019, with the majority being transfers from the Polish state budget (A-/Stable). These transfers are not subject to discretionary changes as most of them are defined by law. Fitch expects Katowice, whose economy is strongly driven by services, to remain attractive to investors and inhabitants, supporting a faster rebound post-pandemic, which we expect from 2022.

Revenue Adjustability: 'Weaker'

We assess Katowice's ability to generate additional revenue in response to possible economic downturns as 'Weaker'. This is in line with that of the majority of Polish cities rated by Fitch. Income tax rates are set by the central government and current transfers decided by the state. Katowice has limited flexibility on local taxes (13% of total revenue), as rates are constrained by ceilings set in national tax regulation. In our view, additional revenue using discretionary tax leeway would not cover 50% of an expected revenue decline in an economic downturn.

The city could increase its revenue by active asset sale (2020: PLN49 million) or upstreaming higher dividends from municipal companies (2020: PLN8 million). However, this source of revenue may prove unsustainable if the economic downturn is prolonged.

Expenditure Sustainability: 'Midrange'

Katowice's 'Midrange' expenditure sustainability is in line with the majority of Polish cities'. The city's main responsibilities are non-cyclical, including education, public transport, municipal services, administration, housing, culture, sport, as well as public safety and family benefits that are mandated by the central government and financed from the central budget.

Historically, Katowice's operating expenditure growth has been in line with revenue growth. Operating margin had been on a downtrend over the last five years before bottoming out at 7% in 2020 (2016: 14%), following declines in one-off revenue, the change in the PIT tax regime and the economic slowdown triggered by the pandemic.

The decrease in operating margin was also caused by additional spending resulting from state decisions (eg increases in minimum wages and teachers' salaries) and accelerating goods and services inflation; and in 2020, by costs for Covid-19 measures. Although the latter will only be temporary, affecting 2020 and 2021, our rating case expects operating margins to average about 5% in 2021-2025.

Expenditure Adjustability: 'Stronger'

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Stronger'. The city's mandatory responsibilities account for about 60% of total expenditure and compared with other Polish cities, Katowice always spend higher amounts to provide citizens with high standard services. Fitch assumes that Katowice could reduce operating expenditure by at least 10% in case of need. In addition, the city can reduce or postpone a significant portion of its capex (after completion of infrastructure investments in 2020-2021). We project capex on average at 14% of total expenditure in 2021-2025 (2020: 20%).

In 2020, which Fitch treats as an extraordinary year due to the pandemic, the city made current expenditure savings following lower utility charges due to temporarily closed schools and kindergartens, cancelled cultural and sport events, reduced purchases of goods and services, as well as lower personnel expenditure. These savings, however, could not compensate for the increase in current spending imposed by state decisions, additional costs for Covid-19 measures and a PLN15 million one-off expenditure for a lost court trial (interest payment in conjunction with the International Congress Centre investment).

Liabilities & Liquidity Robustness: 'Midrange'

National regulations on Polish subnational debt and liquidity are moderate. Katowice's loan portfolio is dominated by loans from international financial institutions (97% at end-2020). This provides the city with a long-term and smooth repayment schedule, with final debt maturity in 2042.

Its debt has floating interest rates, which exposes Katowice to interest-rate risk as Polish cities are not allowed to use derivatives for hedging. Of its outstanding debt at end-2020, almost 10% was in euros and this share will gradually decrease as the city does not plan to incur new debt in foreign currency. Interest-rate and foreign-exchange risks are partly mitigated by the city setting aside more funds than is necessary for debt service.

Katowice's net adjusted debt is low, stemming from payments to a sport and event hall operator (2020: PLN78 million), which we treat as 'other Fitch-classified debt'; debt of municipal companies (2020: PLN185 million), which are self-funded; and guarantees issued for the city's social housing company (2020: PLN3 million). The city administration's policy is not to grant new guarantees and we therefore expect the share of municipal company debt to gradually decrease.

Liabilities & Liquidity Flexibility: 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange', given the absence of emergency liquidity support from upper government tiers and the lack of banks rated above 'A+' in the Polish market. Katowice has a long record of healthy liquidity. The city has a committed but unused credit line of PLN50 million with a large domestic bank.

Cash at the city's bank accounts at end-2020 was PLN455.5 million and included PLN66.9 million of restricted cash, mainly relating to the Governmental Local Investment Fund, a state-imposed Covid-19 support measure, which can be spent on investments only (in 2021-2022). Average cash balances returned to pre-pandemic levels in 1Q21 of PLN510 million, which is a positive rating factor.

Katowice has PLN166 million available under a loan agreement with European Investment Bank (AAA/Stable) to finance investments. The city plans to fully draw down the facility through to end-2023, in line with planned investments.

Debt Sustainability: 'aa category'

Under its rating case for 2021-2025, Fitch has factored in the economic downturn triggered by the pandemic and 2020 results, which were in line with our previous forecasts.

We project that Katowice's debt payback (net adjusted debt-to-operating balance) will remain below 9x in 2021-2025 (2020: 3.1x), which corresponds to a 'aa' debt sustainability assessment. Further debt increase to finance city's capex will lead to weaker synthetic coverage of 1.5x in 2025 ('a' category), versus 4.5x in 2020. Fiscal debt burden will remain below 50% ('aaa' category) despite debt increase. The combination of a sound debt payback and low debt levels in relation to the city's budget offset the weaker coverage ratio to result in a final 'aa' debt sustainability.

The city's operating balance fell to PLN150 million in 2020 from an average PLN200 million in 2015-2019, which was the effect of higher current spending, both related to Covid-19 and to state decisions (eg increases in minimum wages and teachers' salaries). Our rating case expects the operating balance to decline further in 2021-2025 due to tax revenue growth not compensating the prevailing high pressure on current spending. We expect the city's operating balance to be around PLN100 million-PLN140 million in the medium term.

In our rating case, we expect net adjusted debt to increase towards PLN850 million-PLN900 million in 2025 from PLN460 million in 2020, mainly due to a steep increase in direct debt raised to finance the city's investment programme. Katowice plans to take advantage of available non-returnable EU capital grants and state grants (including PLN65 million from the state's Covid-19 support measures) and spend on average around PLN360 million annually on investments. EU, other capital grants, asset sale and dividends covered 40%-50% of Katowice's capex in 2016-2020.

We assume that capital revenue and the current balance will cover on average 72% of the planned capex, with the rest to be debt-financed. Despite assumed high cash balances of at least PLN190 million at year-ends, the expected decrease in operating balance will lead to a weaker debt payback.

DERIVATION SUMMARY

Katowice's 'a-' SCP reflects a 'Midrange' risk profile and 'aa' debt sustainability. The latter is derived from a debt payback at the lower end of the 'aa' category and a weaker coverage ratio corresponding to the 'a' category. Katowice's SCP assessment factors in the city's favourable comparison with national and international peers in the same rating category. The city's IDRs are not affected by any other rating factors and are equal to, but not constrained by, the sovereign's IDRs.

KEY ASSUMPTIONS

Qualitative Assumptions and Assessments:

Risk Profile: 'Midrange'

Revenue Robustness: 'Midrange'

Revenue Adjustability: 'Weaker'

Expenditure Sustainability: 'Midrange'

Expenditure Adjustability: 'Stronger'

Liabilities and Liquidity Robustness: 'Midrange'

Liabilities and Liquidity Flexibility: 'Midrange'

Debt sustainability: 'aa'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap: 'N/A'

Sovereign Floor: 'N/A'

QUANTITATIVE ASSUMPTIONS - ISSUER SPECIFIC

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- On average 3.5 % yoy increase in operating revenue;

- On average 4.2% yoy increase in operating spending;

- Negative net capital balance on average at PLN204 million;

- 1.6% p.a. average cost and up to 20-year maturity for new debt; and

- Municipal companies repaying existing debt and no new guarantees.

RATING SENSITIVITIES

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO NEGATIVE RATING ACTION/DOWNGRADE:

- Downgrade of the sovereign's IDRs; and

- Debt payback rising above 9x on a sustained basis under Fitch's rating case.

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO POSITIVE RATING ACTION/UPGRADE:

- Debt payback below or equal to 7.5x on a sustained basis under Fitch's rating case, provided the sovereign is also upgraded, as the city's IDRs are currently at the same level as the Polish sovereign's.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

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REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the city, either due to their nature or to the way in which they are being managed by the city. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Katowice, City of	LT IDR	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
•	LC LT IDR	A- Rating Outlook Stable	Affirmed	A- Rating Outlook Stable
•	Natl LT	AA+(pol) Rating Outlook Stable	Affirmed	AA+ (pol) Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 27 Oct 2020) (including rating assumption sensitivity)

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National Scale Rating Criteria (pub. 22 Dec 2020)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

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