13 Jun 2019 | Affirmation

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

Fitch Ratings-Warsaw/London-14 June 2019: Fitch Ratings has affirmed the Polish City of Katowice's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'A-'. Fitch has also affirmed the city's National Long-Term Rating at 'AA+(pol)'. The Outlooks are Stable.

The affirmation reflects Fitch's unchanged view that Katowice will maintain a sound overall budgetary performance and strong debt sustainability ratios in the medium term, despite pressure on debt growth following investments. Fitch assesses Katowice's standalone credit profile (SCP) at 'a-'.

Katowice is a medium-sized city with a population of about 300,000 located in the Slaskie region and the region's capital. Its unemployment rate of 1.6% at end-2018 was one of the lowest among Polish cities (5.8% national average). The local economy is dominated by services.

KEY RATING DRIVERS

Revenue (Robustness) Assessed as Midrange

We assess Katowice's revenue robustness as 'Midrange' in view of the city's stable revenue sources with revenue growth prospects in line with national GDP growth. Tax revenue accounted for almost 50% of Katowice's operating revenue in 2018, being based on moderately cyclical economic activities. Personal income tax and local taxes accounted for over 45% of operating revenue, while corporate income tax, being more volatile revenue items, accounted for 5%.

Current transfers accounted for 32% of current revenue in 2018, with the majority being transfers from the state budget (A-/Stable). These transfers are not subject to discretionary changes as the majority of them are defined by law. Fitch expects Katowice to remain attractive to investors and inhabitants, supporting the further development of the city's diversified tax base.

Revenue (Adjustability) Assessed as Weaker

We assess Katowice's ability to generate additional revenue in response to possible economic downturns as limited. This is in line with our assessment for the majority of Polish cities rated by Fitch. Income tax rates and current transfers are set by the central government. Katowice has limited flexibility on local taxes, which accounted on average for about 17% of operating revenue in 2016-2018 as the rates are constrained by ceilings set in national tax regulation.

Expenditure (Sustainability) Assessed as Midrange

The city has a proven track record and good control over operating expenditure. Katowice's responsibilities mainly include non-cyclical expenditures, such as education, public transport, municipal services, and administration. We expect the city's capex to remain high in 2019-2020, driven by large infrastructure investments that will be completed by end-2020. This will lead to a budget deficit up to 13% of total revenue in 2020 before gradually declining to about 5% by 2023 under our rating case.

Expenditure (Adjustability) Assessed as Stronger

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Stronger'. The city can reduce a significant part of its capex (after completion of the infrastructure investments in 2020) and more than 10% of its operating expenditure. In 2018 Katowice's capex amounted to more than PLN310 million or almost 16% of total expenditure and we project that it will rise to an average of about 20% of total expenditure in 2019-2023.

The city's mandatory responsibilities with the least spending flexibility account for about 70% of operating expenditure, including education, social care, administration, public safety and family benefits. Additionally, the city spends 22% more on several non-compulsory services for citizens than urban counties with the lowest spending. This means such spending can be cut back by least at 10% in case of need.

Liabilities and Liquidity (Robustness) Assessed as Midrange

Katowice's loan portfolio is dominated by loans from international financial institutions (IFIs; 99% at end-2018). This provides the city with a long-term and smooth repayment schedule, with final debt maturity in 2035. The repayment structure leads to low refinancing risk for the city, with repayment at no more than 8% of the debt stock annually. The city's debt has floating interest rates, which exposes the city to interest rate risk as Polish cities are not allowed to use derivatives. Over 13% of the debt outstanding at end-2018 was in euros, although the share of foreign currency debt will fall to zero at end-2035. The city partially mitigates those risks by prudently setting aside more funds than is necessary for debt service.

Liabilities and Liquidity (Flexibility) Assessed as Stronger

Fitch assesses the city's liquidity framework as 'Stronger' despite a lack of emergency liquidity support from upper tiers of government in Poland. Katowice has a long track record of high liquidity. Liquidity at end-2018 (PLN484 million of unrestricted cash and a committed liquidity credit line of PLN50 million) exceeded annual debt service of PLN46 million. Our rating case projections foresee a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 6x on average in 2019-2023, compared with an average of 15x in

2015-2018. The city has a committed but unused credit line of PLN50 million provided by PKO BP Bank, a major bank in Poland.

Fitch assesses Katowice's risk profile as 'Midrange', which reflects the combination assessment of three factors at 'Midrange', two factors at 'Stronger' and one at 'Weaker'.

Debt Sustainability Assessment: 'aa'

As with all Polish local and regional governments (LRGs) - Katowice is classified as a type B LRG by Fitch as it covers debt service from its cash flow on an annual basis under our new criteria introduced in April 2019 (Rating Criteria for International Local and Regional Governments).

Under its rating case for 2019-2023, Fitch projects the city's debt payback ratio (adjusted net debt-to-operating balance), which is the primary metric of our debt sustainability assessment for Type B LRGs, will increase, from about 1.3x in 2018. It should, however, remain within the 5x-9x threshold, in line with a 'aa' assessment. For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will increase following investments during the forecast period, to over 50% in 2023 from about 14% in 2018. Strong payback ratio and fiscal debt burden ratio counterbalance the city's slightly weaker actual debt service coverage ratio (DSCR) of about 2x (2018: 4.2x) All these metrics underpin the city's debt sustainability assessment at 'aa'.

Rating Derivation

Katowice's SCP is assessed at 'a-', reflecting a combination of a 'Midrange' risk profile and sound debt sustainability metrics assessed at the 'aa' category under Fitch's rating case for 2019-2023. The city's IDR, which is equal to the SCP and to the sovereign rating, is not affected by any asymmetric risk or extraordinary support from the Polish state.

KEY ASSUMPTIONS

Fitch's key assumptions within our rating case for the issuer for 2019-2023 include:
- Operating revenue CAGR of 4.6%
- Operating expenditure CAGR of 5.2%
- Total capex of over PLN2.5 billion
- Cost of debt rising to 3.2% by 2023 from 2.2% for 2019

RATING SENSITIVITIES

Katowice's IDRs are currently equal to those of the Polish sovereign (A-/Stable). They could be upgraded if the city maintains a sound operating performance, leading to an improving debt payback ratio towards five years on a sustained basis, provided the sovereign is also upgraded.

Negative action on Poland's ratings will be reflected on Katowice's ratings. Negative rating action could also result from a sustained deterioration of operating performance or a significant rise in the city's direct debt, leading to a debt payback ratio above nine years on a sustained basis under Fitch's rating case.

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Applicable Criteria

National Scale Ratings Criteria (pub. 18 Jul 2018)

Rating Criteria for International Local and Regional Governments (pub. 09 Apr 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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