FitchRatings

RATING ACTION COMMENTARY

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

Fri 15 May, 2020 - 4:06 PM ET

Fitch Ratings - Warsaw - 15 May 2020: Fitch Ratings has affirmed the Polish City of Gdansk's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'A-'. The Outlooks are Stable.

The affirmation reflects Fitch's view that Gdansk's operating performance and debt ratios will remain in line with 'A-' rated peers over the medium term, despite an expected economic downturn triggered by the coronavirus pandemic, and the central government's recent decisions to cut personal income tax (PIT) and increase teachers' salaries. Fitch assesses Gdansk's Standalone Credit Profile (SCP) at 'a+'.

While Polish LRGs' most recently available data may not have indicated performance impairment, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and some form of government restrictions are maintained or broadened due to the coronavirus pandemic. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

## KEY RATING DRIVERS

Risk Profile: 'Midrange'

Fitch assesses Gdansk's risk profile as 'Midrange', in line with other Fitch-rated Polish cities'. The risk profile (or debt tolerance) reflects a moderate risk of the city's operating balance shrinking over the medium term to levels that are insufficient to cover debt service or of annual debt service rising above expectation. The risk profile combines one 'Weaker' (revenue adjustability) and one 'Stronger' (expenditure adjustability) key factors - with 'Midrange' assessments of the remaining four factors (revenue and expenditure robustness and liabilities and liquidity framework).

Revenue (Robustness) Assessed as 'Midrange'

We assess Gdansk's revenue robustness as 'Midrange' in view of the city's stable revenue with revenue growth prospects in line with national GDP growth. Tax revenue accounted for 50% of Gdansk's operating revenue (in 2019), and is based on moderately cyclical economic activities. PIT accounted for almost 29% of operating revenue; local taxes for 18%; and corporate income tax (CIT), a more volatile revenue item, accounted for just above 4%. Current transfers accounted for almost 34% of operating revenue (in 2019), the majority of which were transfers from the Polish state budget (A-/Stable). These transfers are not subject to discretionary changes as the majority of them are defined by law. Fitch expects Gdansk to remain attractive to investors and inhabitants, supporting further development of the city's diversified tax base.

Revenue (Adjustability) Assessed as 'Weaker'

We assess Gdansk'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 Fitch-rated Polish cities. Income tax rates and current transfers are set by the central government. Gdansk has limited flexibility on local taxes, which accounted for about 18% of operating revenue on average in 2017-2019 as the rates are constrained by ceilings set in national tax regulation.

Expenditure (Sustainability) Assessed as 'Midrange'

The city has a proven track record of control of operating expenditure growth.

Fitch assesses the expenditure sustainability of the city's spending as 'Midrange', 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 and financed from the central budget.

We expect the city's capex to remain high in 2020-2022, leading to budgetary deficits averaging 8% of total revenue, according to our rating case scenario.

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 more than 10% of its operating expenditure. The city also has scope to scale back capex, which represents a high share of total spending (25% on average in the past 10 years). In 2019, Gdansk's capex was more than PLN680 million or about 18% of total expenditure.

The city's mandatory responsibilities with the least spending flexibility only account for about 65% of operating expenditure, including education, social care, administration, public safety and family benefits. Additionally, the city spends on average 36% more than urban counties with the lowest spending per capita, and this could be reduced.

Liabilities and Liquidity (Robustness) Assessed as 'Midrange'

Fitch assesses the national framework regulations for Polish LRGs liabilities and liquidity as 'Midrange'.

Gdansk's debt portfolio is dominated by loans from IFIs (99% at end-2019) that ensure the city has a long-term and smooth repayment schedule, with final debt maturity in 2043. The repayment structure leads to low refinancing risk for the city, with debt repayment not exceeding 8% of the debt stock annually. The majority (89.2%) of 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. The city partially mitigates this risk with its prudent budget practice, securing in its budget higher amounts for debt service. All debt is in local currency, so the city is not exposed to foreign exchange risk. Indirect risk is negligible.

Liabilities and Liquidity Framework (Flexibility) Assessed as 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' due to a lack of emergency liquidity support from upper tiers of government in Poland. Gdansk has a long track record of high liquidity. Liquidity during 1Q20 (PLN136 million average month-end cash on the city accounts and committed liquidity credit line of up to PLN50 million - provided by Bank Pekao SA; BBB+/Negative) exceeded the 2020 annual debt service of PLN109 million by more than 1.7x. Our rating scenario projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 4.1x on average in 2020-2024, slightly lower than the average in 2014-2019 of 4.8x.

Debt Sustainability Assessment: 'aa'

Under our Rating Criteria for LRGs Fitch classifies Gdansk - like all other Polish LRGs - as type B as it covers debt service from its cash flow on an annual basis.

Fitch has revised its rating-case assumptions to factor in the expected economic downturn triggered by the coronavirus pandemic. Our revised rating case projects a weaker operating balance leading to deterioration of the debt payback ratio (primary metric of debt sustainability for Type B LRGs; net adjusted debt-to-operating balance) in 2020-2021 to above 8x (2019: 2.5x), before it improves to below 7x in 2024.

For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will peak following investments in 2022, but still remain strong at 43% before improving to 39% in 2024.

The strong fiscal debt burden counterbalances the city's slightly weaker synthetic debt service coverage ratio of 1.7x in 2024. All these metrics continue to result in a debt sustainability assessment of 'aa'.

Gdansk is the capital of the Pomorskie Region, in northern Poland, and is the largest and wealthiest city in the region, with a well-diversified local economy. Together with Gdynia and Sopot, the city forms a conurbation with almost 749,000 inhabitants (source: Central Statistical Office in Poland). The conurbation's gross regional product per capita was above PLN75,200 in 2017 (the sixth-highest among 73 sub-regions, based on the latest available data), and exceeded the national average by 45.3%. Unlike the majority of Polish cities, Gdansk's population has been growing (468,158 at the end of June 2019), due to positive net migration and a positive birth rate (6.4 and 0.1 per 1000, respectively, at the end of June 2019).

## DERIVATION SUMMARY

Fitch assesses Gdansk's SCP at 'a+', which results from a Midrange assessment of the city's risk profile and 'aa' assessment of debt sustainability, stemming from a payback ratio at the upper end of the 'aa' category and moderate debt level corresponding with the 'aaa' category. Gdansk'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, but are constrained by the sovereign's IDR.

## 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' category

Support: N/A

Asymmetric Risk: N/A

Sovereign cap: Yes

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 2015-2019 figures and 2020-2024 projected ratios.

The key assumptions for the rating case include:

- Operating revenue CAGR of 3.5% in 2020-2024

- Operating expenditure CAGR of 4.4% in 2020-2024

- Capital revenue averaging 4% of total revenue and capex averaging 11% of total expenditure up to 2024

- Average debt costs rising to 4.0% in 2024 from 1.9% in 2019

## RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Upgrade of the sovereign IDR

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Downgrade of the sovereign IDR

- Weakening of the city's debt metrics, with a debt payback ratio sustainably exceeding 9x under Fitch's rating case.

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF 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 entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

## RATING ACTIONS

| ENTITY/DEBT | RATING | | |
|---|---|---|---|
| Gdansk, City of | LT IDR | A- | Affirmed |
| • | LC LT IDR | A- | Affirmed |
| • | Natl LT | AAA(pol) | Affirmed |

VIEW ADDITIONAL RATING DETAILS

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## APPLICABLE CRITERIA

National Scale Ratings Criteria (pub. 18 Jul 2018)

Rating Criteria for International Local and Regional Governments (pub. 13 Sep 2019) (including rating assumption sensitivity)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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