FitchRatings

**RATING ACTION COMMENTARY**

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

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Fitch Ratings - Warsaw - 16 Apr 2021: 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 unchanged view that Gdansk's operating performance and debt ratios will remain sound over the medium term, despite an economic downturn triggered by the coronavirus pandemic. Fitch assesses Gdansk's Standalone Credit Profile (SCP) at 'a+' and the city's ratings remain capped by the sovereign at 'A-'.

## 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 our assessment of one 'Weaker' (revenue adjustability) key factor, one 'Stronger' (expenditure adjustability) key factor and four other at 'Midrange' (revenue and expenditure robustness and liabilities and liquidity framework).

Revenue Robustness: '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 over 46% of Gdansk's operating revenue in 2020, and is based on moderately cyclical economic activities. Personal income tax (PIT) accounted for more than 26% of operating revenue, followed by local taxes at more than 16%; and corporate income tax (CIT), a more volatile revenue item, at just above 3%. Current transfers accounted for almost 40% of operating revenue in 2020, 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.

In 2020 the city's revenue was affected by the central government's decision to cut PIT rates, as a result of which tax revenue fell 2.9% to PLN932 million versus CAGR of 10% in 2015-2019. Lockdown measures due to the pandemic also had an impact on the city's revenue, with public transport ticket revenue down 32% at PLN83 million in 2020. The pandemic also reduced the city's revenue from CIT by 19%, while the civil transaction tax paid mainly on real-estate transactions rose 2%, despite recession.

Revenue Adjustability: 'Weaker'

We assess Gdansk's ability to generate additional revenue in response to 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 just above 16% of operating revenue in 2020 as rates are constrained by ceilings set within national tax regulation. In our view, additional revenue using discretionary tax leeway would cover less than 50% of an expected revenue decline in an economic downturn.

Expenditure Sustainability: 'Midrange'

The city has a record of moderate control over operating expenditure growth. Fitch assesses the expenditure sustainability of the city as 'Midrange', in line with the majority of Polish cities'. The city's main responsibilities are moderately non-cyclical, which include 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 2021-2022, leading to budget deficits averaging 8% of total revenue under our rating case.

Expenditure Adjustability: 'Stronger'

The city's mandatory responsibilities with the least spending flexibility only account for about 65% of operating expenditure, which include 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, which could be reduced if needed.

The city could reduce more than 10% of its operating expenditure, as it had partially done during 2020. It also has scope to scale back capex, which represents a high share of total spending (24% on average in the past 10 years). In 2020 Gdansk's capex was more than PLN625 million or about 16% of total expenditure.

Overall, we assume the city has strong affordability to cut spending in response to shrinking revenue.

Liabilities and Liquidity Robustness: 'Midrange'

Gdansk's debt portfolio comprises loans from international financial institutions, which ensure a long-term and smooth repayment schedule, with a final debt maturity in 2044. The repayment structure leads to low refinancing risk, with debt repayment at no more than 7% of the debt stock annually.

Although the share of fixed-rate instruments in the city's debt portfolio increased substantially during 2020 to above 43%, from 11% at end-2019, the majority of the city's debt is still at floating 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 management, by setting aside higher amounts than necessary for debt service. All debt is in local currency, resulting in zero foreign-exchange risk. Indirect risk is low.



Liabilities and Liquidity Flexibility: 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' due to moderate counterparty risk, as banks providing liquidity in Poland are rated between 'BBB-' and 'A+'. Additionally, emergency liquidity support is absent from upper tiers of government in Poland. However, Gdansk has a long history of high liquidity. Liquidity during 2020 (more than PLN178 million average month-end cash and a committed liquidity credit line of up to PLN50 million provided by Bank Pekao SA; (BBB+/Negative)) exceeded 2021 annual debt service of PLN69.7 million by more than 3.3x. Our rating case projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 7.8x on average in 2021-2025, versus an average in 2016-2020 of 5.1x.

Debt Sustainability: 'aa' category

Under our Rating Criteria for Local and Regional Governments (LRGs) Fitch classifies Gdansk - similarly to all other Polish LRGs - as type B since it covers debt service from its cash flow on an annual basis.

Fitch's rating-case assumptions factor in the economic downturn triggered by the coronavirus pandemic. In our rating case we project a further weakening of the operating balance in 2021, which will erode debt payback (primary metric of debt sustainability for type B LRGs; net adjusted debt-to-operating balance) to above 5x (2020: 3.2x). Increasing debt will also contribute to debt payback remaining at 5x-6x in the medium term. For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will peak following investments in 2023, but still remain strong at below 37% before improving to 33% in 2025.The synthetic debt service coverage ratio remains above 2x throughout our rating case. All these metrics result in an overall debt sustainability assessment at the upper end of the 'aa' category.

The central government's decisions to cut PIT and increase teachers' salaries, and the economic slowdown triggered by the pandemic may continue to lead to a mismatch between operating revenue and expenditure, weakening the city's operating results further in 2021. Gdansk's operating balance declined to PLN245 million in 2020, or 7% of operating revenue, from PLN313 million in 2019 and was materially below the average of PLN360 million in 2016-2019. Fitch's rating case expects the city's operating balance to decline further in 2021, before moderately improving in 2022-2025.



In 2013-2018, sound operating performance and high levels of acquired non-returnable investment grants allowed the city to reduce its direct debt to PLN722 million at end-2018 from PLN1,404 million at end-2012. Since 2019 the city's direct debt resumed its upward trend following new investments. Under our rating case, we expect Gdansk's adjusted debt to increase to above PLN2 billion at end-2023 from PLN1.1 billion at end-2020.

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 753,000 inhabitants (source: Central

Statistical Office in Poland). The conurbation's gross regional product per capita was above PLN82,360 in 2018 (the sixth-highest among 73 sub-regions, based on the latest available data), and exceeded the national average by 49%. Unlike the majority of Polish cities', Gdansk's population has been growing (471,525 at end-1H20), due to positive net migration and a positive birth rate (6.5 and 1 per 1,000, respectively, at end-2019).

## DERIVATION SUMMARY

Fitch assesses Gdansk's SCP at 'a+', which results from a 'Midrange' risk profile and 'aa' debt sustainability. The latter is derived from a debt payback at the upper end of the 'aa' category and moderate debt levels corresponding with the 'aaa' category. The SCP also 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'

Budget Loans (Notches): 'N/A'

Ad-Hoc Support (Notches): 'N/A'

Asymmetric Risks (Notches): 'N/A'

Rating Cap: 'A-'

Rating 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. Key assumptions include:

- Annual average 3.7% increase in operating revenue, including tax revenue CAGR 4.4% and transfers received CAGR 2.7%;

- Annual average 3.9% increase in operating spending;

- Net capex PLN325 million on average (similar to historical average);

- Average cost of debt increasing to 2.1% in 2025 from 1.2% in 2020 and long-term maturities of new debt (up to mid-2040); and

- Poland experiences a recovery in economic growth after an initial, sharp shock from the pandemic.

**RATING SENSITIVITIES**

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

- A downgrade of the sovereign's IDR

- A multiple-notch downward revision of the city's SCP below 'a-', which could be driven by material deterioration in debt metrics, particularly a 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:

- An upgrade of the Polish sovereign IDR, as the city's IDRs are currently constrained by those of the sovereign.

ESG CONSIDERATIONS

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

## 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.

## 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.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The city of Gdansk's IDRs are capped by the IDR of the Polish sovereign.

## RATING ACTIONS

| ENTITY/DEBT | RATING | | | PRIOR |
|---|---|---|---|---|
| Gdansk, 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 | AAA(pol) Rating Outlook Stable | Affirmed | AAA(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)

National Scale Rating Criteria (pub. 22 Dec 2020)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
| Gdansk, City of | EU Issued, UK Endorsed |

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