FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Warsaw - 15 Oct 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-'.

In September 2021, the central government announced a reform proposal called the 'Polish Deal', which has introduced an element of uncertainty to the financial stability of local and regional governments. It is a policy package that includes changes to the income tax law that would sharply reduce revenue for the country's municipalities, which would be credit negative. However, it is unclear what will be the ultimate shape of these plans due to the ongoing legislation process. Furthermore, because the full impact of the deal will depend on the offsetting measures from central and municipal governments, we have not incorporated these changes in our current rating scenarios.

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 risk factor, one 'Stronger' (expenditure adjustability) key risk 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 the 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, 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 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, 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, which could be reduced if needed.

The city could reduce more than 10% of its operating expenditure, as it partially did 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.

The share of fixed-rate instruments in the city's debt portfolio increased substantially during 2020 to above 43%, from 11% at end-2019. However, the majority of the city's debt is still floating rate, which exposes the city to interest rate risk as Polish cities are not allowed to use derivatives. The city mitigates this risk with prudent budget management, 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.

Fitch included the debt of the city's municipal company Port Czystej Energii (PCE) - aimed at financing the solid waste thermal neutralisation facility - into "Other Fitch classified debt" as the investment has been concluded in SPV structure. The facility is currently in construction phase and will not be fully operational until 2024.

The company incurred a preferential loan from the National Fund for Environment Protection and Water Management (PLN294 million, maturing in 2044) and repayments will start in 2024. The city has extended a guarantee on this debt, which will be maintained at least until the facility is operational and PCE begins receiving revenue. The city is not expected to provide the company with funds for debt service, but the entrustment agreement between Gdansk and PCE includes a clause that the city will make sure PCE is financially sustainable, providing capital injections or subsidies if needed.

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+/Stable)) 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 LRGs Fitch classifies Gdansk - like 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: 3.3x). Increasing debt will also contribute to debt payback rising above 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 remain strong at below 43% before improving to 38% in 2025.The synthetic debt service coverage ratio remains 2x on average 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, further weakening the city's operating results 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. Our rating case scenario does not incorporate the effects of the introduced Polish Deal as it has not yet been approved and the full impact on the city's budget is unknown.

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.

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 the 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

- Effects of the introduced Polish Deal not included in the scenario as the impact on the city is unknown.

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.

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.

ISSUER PROFILE

Gdansk is the capital of the Pomorskie Regionwith a well-diversified local economy. Together with Gdynia and Sopot, the city forms a conurbation with just over 751,000 inhabitants (source: Central Statistical Office in Poland). The conurbation's gross regional product per capita was above PLN82,360 in 2018 and exceeded the national average by 49%. Unlike the majority of Polish cities', Gdansk's population has been growing (470,805 at end-2020), due to positive net migration and a positive birth rate (6.5 and 1 per 1,000, respectively, at end-2019).

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

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

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

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

National Scale Rating Criteria (pub. 22 Dec 2020)

International Local and Regional Governments Rating Criteria (pub. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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