FitchRatings

RATING ACTION COMMENTARY

Fitch Maintains Polish City of Gdansk on Rating Watch Negative

Fri 08 Apr, 2022 - 5:08 PM ET

Fitch Ratings - Warsaw - 08 Apr 2022: Fitch Ratings has maintained the Polish City of Gdansk's 'A-' Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) and 'AAA(pol)' National Long-Term Rating on Rating Watch Negative. A full list of rating actions is below.

The maintained RWN reflects Fitch's uncertainty about the financial impact of the 'Polish Deal' fiscal reform on Gdansk's budget. On 24 March 2022, the state government announced significant changes to the Polish Deal just three months after the bill's introduction in January 2022. The proposed amendments, among others, include the lowering of the first tax threshold of the personal income tax (PIT) to 12% from 17%, to come into force from 1 July 2022. The envisaged changes will significantly impact the Polish municipalities' funding system, further reducing their tax revenues, which were already expected to be lower due to the original version of the tax reform (compared with without the reform). For Gdansk we need to review our scenario analysis as it may lead to a change in the financial profile and impact the ratings.

The tax reform affects the local governments' (LG) PIT revenue from 2022, and we believe the reported strong increase in PIT revenue in 2021 will not be sufficient to compensate the expected drop in the medium term. PIT constitutes on average more than 25% of the total revenues of Fitch-rated Polish municipalities. In our opinion, the compensatory measures envisaged in the regulation on the LGs' revenue system introduced from January 2022, was already insufficient to fully compensate the expected drop in PIT revenue.

It is difficult to estimate if the recently proposed bill amendment will further increase the gap between the drop in revenue and the compensation from the state budget, as the details of the law are currently unknown. The municipalities will be forced to implement measures, such as increasing local taxes and fees and reducing of current spending, to counteract the revenue fall.

Fitch plans to resolve the RWN as soon as practicable, once the final scope of the currently discussed bill amendments is known.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

We do not expect that the key risk factors will be affected by the Polish Deal tax reform. 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 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 48% of Gdansk's operating revenue in 2021, and is based on moderately cyclical economic activities. PIT accounted for almost 28% of operating revenue, followed by local taxes at 17%; and corporate income tax (CIT), a more volatile revenue item, at 3.6%.

Following the Polish Deal reform, the city received PLN114 million of the extra subsidy from the state (end of the 2021 financial year) as partial compensation for the PIT decline in 2022. We have adjusted the city's extra subsidy because it does not correlate with the expected decline in PIT revenue (2022 onwards), withdrawing it from 2021 and added the subsidy in 2022 so we do not distort the city's operating balance trend.

Current transfers were the city's second-largest operating revenue source and they accounted for almost 36% of operating revenue in 2021 (when excluding the additional subsidy). 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.

In 2021, Gdansk's operating revenue grew strongly, by more than 12% yoy, mainly driven by high growth of tax revenue (almost 16.8%), which was fuelled by better than expected growth of the national economy as well as inflation-driven wage increases. The city reported PLN1.197 million PIT revenue (27.6% of operating revenue), PLN145 million of CIT (3.6%) and PLN530 million (13.4%) real estate tax.

Fitch expects Gdansk to remain attractive to investors and inhabitants, supporting further development of the city's diversified tax base.

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 around 17% of operating revenue in 2021 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 2022, leading to a budget deficit above 10% of total revenue.

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 and 2021. It also has scope to scale back capex, which represents a high share of total spending (22% on average in the past 10 years). In 2021, Gdansk's capex was more than PLN567 million or about 14% of total expenditure.

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

Liabilities & 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 10% of the debt stock annually.

The share of fixed-rate instruments in the city's debt portfolio increased substantially during 2020-2021 to just below 45%, from 11% at end-2019. However, more than half of the city's debt still has floating rates, 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 & 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 2021 (more than PLN370 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's annual debt service of PLN60.7 million by more than 6x. Liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) averaged in 2016-2020 at 5.1x.

Debt Sustainability: 'aa category'

As stated in December 2021, we expect changes to the debt sustainability (DS) assessment, which in turn may lead to a change in the Standalone Credit Profile (SCP) and may impact Gdansk's IDRs. However, the recent announcement of a further significant change to the Polish Deal tax reform means we cannot make our scenarios more specific due to the uncertainty regarding the main factors affecting the financial situation. These include the expected decrease in PIT revenue and the amount of development subsidy due, which is aimed at fully compensating the expected revenue loss.

Comparing the preliminary results for 2021 with our base rating case scenarios made in 2021, we see that the city outperformed our expectations. The operating balance reported on a preliminary basis was PLN380 million, when excluding the additional subsidy of PLN114 million, whereas we expected PLN262 million in the base and PLN230 million in the rating case scenario. Net adjusted debt amounted to PLN865 million, which was also below our last year's expectations (PLN1,168 million and PLN1,225 million, respectively).

Given the positive financial development in 2021, we therefore uphold our base and rating case scenarios for 2021-2025 as long as the new envisaged law adjustments have not been approved. Under its rating case for 2021-2025, Fitch projects the city's payback ratio will remain at 'aa' DS score and the weaker synthetic debt service coverage ratio at 'a' DS score. Fitch's rating case projects that the fiscal debt burden will increase but remain strong ('aaa' DS score). All these metrics continue to justify the city's balanced debt sustainability assessment at 'aa'.

DERIVATION SUMMARY

During the last review on 15 October 2021, Fitch assessed Gdansk's SCP at 'a+', which resulted from a 'Midrange' assessment of its Risk Profile and 'aa' assessment of DS. The city's SCP assessment factors in positioning among peers in the same rating category. Fitch may revise the SCP down depending on the ultimate impact of the Polish Deal. The city's IDRs are not affected by any other rating factors, but are constrained by the sovereign's IDR.

KEY ASSUMPTIONS

Qualitative and quantitative assumptions remain intact as during the last review on 3 December 2021:

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: 'A-'

Sovereign Floor: 'N/A'

Quantitative assumptions - Issuer Specific

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

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for [2020] and forecast for [2022], respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action):

Summary of Financial Adjustments

We have adjusted a one-off subsidy resulting from the Polish Deal paid in December 2021 but for cost coverage in 2022 (withdrawing from current transfer in 2021 /added in 2022).

Issuer Profile

Gdansk is the capital of the Pomorskie Region with 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 close to PLN90,000 in 2019 and exceeded the national average by 51%. Unlike the majority of Polish cities', Gdansk's population has been growing (470,633 at end-1H21), due to positive net migration and a positive birth rate.

RATING SENSITIVITIES

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

Fitch expects to resolve the RWN over the coming months, potentially with a downgrade, subject to tax revenue decline not compensated by Gdansk's measures, leading to operating balance deterioration and increasing debt financing needs and the debt payback ratio rising above 9x on a sustained basis under Fitch's rating case.

Downgrade of Poland's sovereign ratings.

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

The RWN could be removed and the ratings affirmed if Gdansk's DS and SCP are unaffected considering all measures implemented to counteract the fall in PIT revenue due to the Polish Deal fiscal reform.

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

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Gdansk's IDRs are capped by Poland's IDRs.

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 Rating

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

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Gdansk, City of	LT IDR	A- Rating Watch Negative Rating Watch Maintained	A- Rating Watch Negative

	LC LT IDR	A- Rating Watch Negative Rating Watch Maintained	A- Rating Watch Negative
	Natl LT	AAA(pol) Rating Watch Negative Rating Watch Maintained	AAA(pol) Rating Watch Negative

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

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Gdansk, City of	EU Issued, UK Endorsed

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