



RATING ACTION COMMENTARY

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

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Fitch Ratings - Warsaw - 24 Mar 2023: 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 of Gdansk's ratings reflects Fitch's view that the city's operating performance and debt ratios will remain in line with 'A-' peers over the medium term, despite pressures on the city's budget stemming from increasing prices, continued macroeconomic spill over from the war in Ukraine and the implementation of the Polish Deal tax reform.

Fitch assesses Gdansk's Standalone Credit Profile (SCP) at 'a-', reflecting a combination of a 'Midrange' risk profile and the lower end of 'aa' debt sustainability. The city's IDRs are equal to the sovereign (Poland; A-/Stable), and are not affected by other rating factors.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Gdansk's 'Midrange' risk profile is in line with other Fitch-rated Polish cities. The risk profile (or debt tolerance) reflects the 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 expectations. 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'

The city's revenue sources are stable with revenue growth prospects in line with national GDP growth. The additional transfers from the state budget envisaged in the Polish Deal reform, i.e., from a 'A'-rated counterparty, will help support revenue stability.

Tax revenue accounted for over 46% of Gdansk's operating revenue in 2022 (including the additional share of personal income tax (PIT) local and regional governments (LRG) received in 2022, which was to compensate lower PIT revenue in 2023), and is based on moderately cyclical economic activities. Current transfers (adjusted upward for the additional subsidy received by end-2021) accounted for 35% of operating revenue in 2022, the majority of which was transfers from the Polish state budget. These majority of these transfers are defined by law.

Revenue Adjustability: 'Weaker'

In our opinion, the compensatory measures envisaged in the amended regulation for the LG revenue system will be insufficient to fully compensate the lower PIT revenue. Municipalities will have to increase local taxes and fees. However, 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.

Gdansk has limited flexibility on local taxes, which accounted for just above 17% of operating revenue in 2022 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. The results for 2022 have been inflated by the additional share of PIT (PLN132 million) received by the city in 2022, which was intended to support revenue in 2023. At present, there is no official indication that similar support will be granted by the state budget in 2023.

Expenditure Sustainability: 'Midrange'

The Polish Deal reform does not affect the expenditures of municipalities so our assessment is unchanged. However, the municipalities will need to continue to implement measures, such as reducing current spending, to counteract the revenue fall. This will be challenging, given the high inflation environment (18.4% inflation in February 2023), pressurising the cost of goods and services (29% of operating spending) and wages, which are inflexible and accounted for 37% on average in 2017-2022.

The city has a record of moderate control over operating expenditure growth. Fitch assesses the expenditure sustainability as 'Midrange', in line with the majority of cities in Poland. The city's main responsibilities are moderately non-cyclical, including education, public transport, municipal services, administration, housing, culture, sport, as well as public safety .

Expenditure Adjustability: 'Stronger'

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

The city could reduce about 10% of its operating expenditure, as it partially did in previous years. 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 2022, Gdansk's capex was more than PLN600 million or about 13.5% 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 final debt maturity in 2044. The repayment structure leads to low refinancing risk, with debt repayment at no more than 8% of the debt stock annually.

The share of fixed-rate instruments in the city's debt portfolio has increased substantially to above 47%, from 11% at end-2019. However, the majority of the city's debt still carries 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.

The city guarantees the debt (2022: PLN194 million, maturing in 2044) of its company Port Czystej Energii (PCE) - aimed at financing the solid waste thermal neutralisation facility - as the investment has been concluded in an SPV structure. The guarantee will be maintained at least until the facility is operational and PCE begins receiving revenue (2025). 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 2022 (more than PLN490 million average month-end cash and a committed liquidity credit line of up to PLN100 million provided by Bank Pekao S.A.; (BBB/Stable)) exceeded 2022 annual debt service of PLN89 million by more than 6.6x.

Our rating case projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 2.7x on average in 2023-2027, versus an average in 2019-2022 of 7.1x.

Debt Sustainability: 'aa category'

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

We believe that future subsidies from the state budget will be insufficient to compensate for the financial implications of the Polish Deal reform. This will lead to weaker debt metrics, although they will remain in line with the 'a-' SCP.

Fitch's rating-case assumptions factor in the central government's decisions to cut PIT in 2022, income tax distribution to LRGs introduced by the Polish Deal, high inflation and the economic slowdown in 2023, which together will lead to a continued mismatch between operating revenue and expenditure growth over the medium term. In our rating case, we project a further weakening of the operating balance in 2023-2027 and an increase of debt, which will erode debt payback to above 8x (2022: 2.3x) in the medium term.

For the secondary metrics, Fitch's rating case projects that the fiscal debt burden ratio will peak following investments in 2024, but remain strong at below 35% before improving to 29% in 2027. We estimate the synthetic debt service coverage ratio will remain at 1.2x on average throughout 2024-2027 in our rating case. These metrics result in an overall debt sustainability assessment at the lower end of the 'aa' category.

Gdansk's operating balance, despite being inflated by the additional PIT revenue received in 2022, declined to PLN324 million in 2022, or 7.8% of operating revenue, from PLN379 million in 2021 (both values adjusted for the additional subsidy of PLN114 million earmarked for 2022, but received by end of 2021). Fitch's rating case

expects the city's operating balance to decline further in 2023 to a low PLN64 million, as the city already received compensation for lower PIT revenue in 2023 in 2022, before it rebounds to an average of around PLN170 million, which will still be just above 50% of the last four years' average of PLN315 million.

We expect the city's capex to remain high in 2023, as the city is finalising EU 2014-2020 budget co-financed projects, leading to a budget deficit of 13.5% of total revenue under our rating case. We expect Gdansk's adjusted debt to increase to above PLN1.7 billion at end-2024 from PLN1.0 billion at end-2022, following the current investment plan.

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 lower 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.

KEY ASSUMPTIONS

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 (LT IDR): 'A-'

Sovereign Cap (LT LC IDR) 'A-'**Sovereign 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 2018-2022 figures and 2023-2027 projected ratios. The key assumptions for the scenario include:

- Annual average 2.6% increase in operating revenue, including tax revenue CAGR 3.3% and transfers received CAGR 1.5%;
- Annual average 3.6% increase in operating spending;
- Net capex PLN189 million on average;
- Average cost of debt increasing to 5.2% in 2023-2027 from 1.9% in 2018-2022 and long-term maturities of new debt (up to mid-2040);

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for 2021 and forecast for 2023-2024, 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 November and December 2021 for cost coverage in 2022 by subtracting it from current transfers in 2021 and adding it back 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 762,470 inhabitants (source: Central Statistical Office in Poland). The conurbation's gross regional product per capita was above PLN90,000 in 2020 and exceeded the national by more than 50%. Unlike the majority of Polish cities, Gdansk's population has been growing (486,226 at end-1H2022 vs. 463,726 end 2016), due to positive net migration compensating for the negative birth rate.

RATING SENSITIVITIES

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

A downgrade of Poland's sovereign ratings;

- A downward revision of the SCP, which could be driven by deterioration in debt metrics, particularly 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:

- Debt payback ratio remaining lower or equal to 7.5x on a sustained basis under Fitch's rating case, provided the sovereign was also upgraded, as the city's IDRs are currently equal to those of the Polish 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

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Gdansk's ratings are equal to 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>.

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 Outlook Stable	A- Rating Outlook Stable
	Affirmed		
	LC LT IDR	A- Rating Outlook Stable	A- Rating Outlook Stable
	Affirmed		
	Natl LT		AAA(pol) Rating Outlook Stable
	AAA(pol) Rating Outlook Stable		
	Affirmed		

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)

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Gdansk, City of

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