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RATING ACTION COMMENTARY

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

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Fitch Ratings - Warsaw - 22 Sep 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 reflects Fitch's continued 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 Polish Deal tax reform.

## 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' key risk factor, one 'Stronger' key risk factor and four at 'Midrange'.

**Revenue Robustness: 'Midrange'**

This assessment reflects the city's stable revenue sources with revenue growth prospects in line with national GDP growth. Tax revenue accounted for over 46% of Gdansk's operating revenue in 2022 (including the additional share of personal income tax (PIT) that local and regional governments (LRG) received in 2022, although it was to compensate lower PIT revenue in 2023), and is based on moderately cyclical economic activities. PIT accounted for more than 26% of operating revenue, followed by local taxes at over 16%; and corporate income tax (CIT), a more volatile revenue item, at just below 4%.

Current transfers (adjusted upward for the additional subsidy received by end-2021) accounted for 35% of operating revenue in 2022, the majority of which were transfers from the Polish state budget (A-/Stable). These transfers are not subject to discretionary changes as the majority are defined by law. The additional transfers from the state budget envisaged in the Polish Deal reform, i.e. from a 'A'/'BBB' rated counterparty, will help support revenue stability.

**Revenue Adjustability: 'Weaker'**

In our opinion, the compensatory measures envisaged in the amended regulation for the local government revenue system will be insufficient to fully compensate lower PIT revenue. Municipalities will need to continue to implement measures such as increasing 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.

Income tax rates and current transfers are set by the central government. 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.

**Expenditure Sustainability: 'Midrange'**

The "Polish Deal" reform does not affect municipalities' expenditure so our assessment is unchanged. However, they 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 (10.1% inflation in August 2023), pressurising not only the cost of goods and services (29% of operating spending) but also wages, which are inflexible and accounted for 37% on average in 2017-2022. Prices of electricity, heating and fuel have increased at an unprecedented pace, jeopardising the city's efforts to reduce spending.

The city has a record of moderate control over operating expenditure growth. Fitch assesses the city's 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 and family benefits that are mandated and financed from the central budget.

**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 with the lowest spending per capita, which 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.

**Liabilities & Liquidity Flexibility: 'Midrange'**

This assessment reflects 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 2023 (more than PLN260 million average month-end cash and a committed liquidity credit line of up to PLN100 million provided by Bank Pekao SA; BBB/Stable) has exceeded budgeted 2023 annual debt service of PLN127.9 million by more than 3x.

**Debt Sustainability: 'aa category'**

We continue to 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 commensurate with the Standalone Credit Profile (SCP) of 'a-'.

Fitch's rating-case assumptions factor in that 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 will to 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 substantially erode debt payback (primary metric of debt sustainability for type B LRGs; net adjusted debt-to-operating balance) to above 14x in 2023, before it begins improving back towards 7x (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 below 30% in 2027.The synthetic debt service coverage ratio remain at 1.5x on average throughout 2025-2027 in our rating case. These metrics result in an overall debt sustainability assessment at the lower end of the 'aa' category.

In 1H23 Gdansk reported sound operating results, with an operating balance of PLN258 million (end-1H22: PLN289 million), which accounted for about 12% of operating revenue. Good operating results and slower capex resulted in an intra-year budget surplus of PLN72 million. Fitch expects a moderate acceleration of capex, particularly in 4Q23, although some of the scheduled 2023 capex may still slip into 2024. Fitch believes the city's budget deficit may exceed 7% of total revenue in 2023, and then remain above 3% on average in the medium term following the roll-out of new investments, which are co-financed from the 2021-2027 EU budget.

Fitch's rating case expects the city's operating balance to continue to decline in 2023 to a low PLN72 million, before it rebounds to an average of around PLN180 million per year, which will still be just below 60% of the last four-year average of PLN315 million. Under our rating case, we expect Gdansk's net adjusted debt to increase to above PLN1.4 billion at end-2027 from PLN744 million at end-2022, following the investment plan.

## DERIVATION SUMMARY

Fitch assesses Gdansk's SCP at 'a-', which results from a 'Midrange' risk profile and 'aa' debt sustainability. The SCP also factors in the city's 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 at the same level as the sovereign IDRs.

### National Ratings

Gdansk's National Rating of 'AAA(pol)' is the highest possible under Fitch's National Rating scale.

## 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'**

**Rating Cap (LT IDR): 'A-'**

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

- Annual average 2.7% increase in operating revenue, including tax revenue CAGR 3.5% and transfers received CAGR 1.5%

- Annual average 3.5% increase in operating spending; increase in operating spending; due to inflationary increases of public transport services provision costs, as well as salary growth pressure driven by increased minimum wages

- Net capex PLN236 million on average

- Average cost of debt increasing to 4.8% 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 2022 and forecast for 2023-2025, respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action)

### Liquidity and Debt Structure

Our rating case projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 2.9x on average in 2023-2027, versus an average in 2018-2022 of 6.7x.

We expect the city's capex to remain high at 14% in 2023, as the city is finalising EU 2014-2020 budget co-financed projects, leading to a budget deficit of 7% of total revenue under our rating case. In the medium term, Fitch expects the share of capex to increase to between 15%-20%, as the city will be rolling out investments under the new EU budget for 2021-2027.

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 debt still carries floating rates, which expose 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 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.

The facility is currently in the 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 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.

### 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 761,490 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 (486,345 at end-2022 vs. 463,726 end 2016), due to positive net migration compensating for the negative birth rate.

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.

## 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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

### Sources of Information

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

## DISCUSSION NOTE

Committee date: 19 September 2023

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Gdansk's ratings are at the same level as the sovereign.

### 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<br>Affirmed | A- Rating Outlook Stable |
| | LC LT IDR | A- Rating Outlook Stable<br>Affirmed | A- Rating Outlook Stable |
| | Natl LT | AAA(pol) Rating Outlook Stable<br>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

## ENDORSEMENT STATUS

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

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. Sector-specific best- and worst-case scenario credit ratings are listed in more detail at https://www.fitchratings.com/site/re/10238496

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