FitchRatings

RATING ACTION COMMENTARY

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

Fri 15 Mar, 2024 - 5:03 PM ET

Fitch Ratings - Warsaw - 15 Mar 2024: 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. A full list of rating actions is below.

The affirmation reflects Fitch's unchanged view that the city's operating performance and debt ratios will remain in line with 'A-' peers over the medium term. We forecast a deterioration of the payback ratio in the medium term, due to continued high investment expenditure requiring debt finance, coupled with weaker operating performance expectations. Changes to the local and regional governments' (LRGs) funding mechanism, which started with the Polish Deal tax reform, and still high inflation will continue to put pressure on the city's operating balance

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 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 expectations.

Revenue Robustness: 'Midrange'

We assess Gdansk's revenue robustness unchanged as 'Midrange' in view of 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 2023, and is based on moderately cyclical economic activities.

Personal income tax (PIT) accounted for almost 22% of operating revenue, followed by local taxes at more than 20%; and corporate income tax (CIT), a more volatile revenue item, at just above 4%. Current transfers accounted for 33% of operating revenue in

2023, 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.

Revenue Adjustability: 'Weaker'

This assessment reflects Gdansk's limited ability to generate additional revenue. This is in line with our assessment for all Fitch-rated Polish local and regional governments (LRG), as income tax rates and current transfers are set by the central government, which significantly limits LRGs' flexibility in increasing revenue. Gdansk has also limited flexibility on local taxes, 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 Polish Ministry of Finance recently introduced proposals for significant reform of local government financing. These include categorising local governments to allocate funds based on individual needs, abolishing the "Janosikowe" financial adjustment mechanism, and changing the sources of local government funding and the subsidy system. One key aspect is that local government shares of PIT and CIT would be calculated based on taxable income, not affected by tax reliefs or exemptions, making them less sensitive to changes in tax legislation. The details are expected to be revealed during 2024, with implementation from 2025.

Expenditure Sustainability: 'Midrange'

This assessment reflects an historical pattern of operating expenditure growth tracking operating revenue growth. The city has a record of moderate control over operating expenditure growth. The 'Midrange' assessment is 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 only 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 (18% on average in the past 10 years). Overall, we assume the city still 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 2047. The repayment structure leads to low refinancing risk, with debt repayment at no more than 7% of the debt stock annually.

As of end-2023, fixed-rate obligations constituted 35% of the city's debt composition. However, a substantial portion of this debt is scheduled for re-fixing of interest rates at end-2024 and midway through 2025, initiating a new term in accordance with the lending agreements. This scenario exposes the city to interest rate volatility, as Polish municipalities are not allowed to use derivatives. However, the city employs conservative fiscal strategies, earmarking reserves that exceed its debt servicing requirements, mitigating potential interest rate fluctuations. All debt is in local currency, resulting in zero foreign-exchange risk. Indirect risk stemming from municipal companies' debt is low relative to the city's budget.

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 2023 (more than PLN320 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 2023 annual debt service of PLN95million by almost 4.5x.

There was a notable reduction in surplus cash balances by end-2023 to PLN57 million from PLN280 million at end-2022, due to a strategic choice to utilise cash for capex rather than accruing interest bearing debt. However, our rating case indicates that the city's liquidity will remain consistently sound throughout the rating horizon.

Our rating case projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 4.9x on average in 2024-2028, versus an average in 2019-2023 of 11x.

Debt Sustainability: 'aa category'

Under its rating case for 2024-2028, Fitch projects the city's payback ratio will rise to above 9x in 2024 (2023: 4.7x) and then return towards 7x by 2028. The deterioration of the payback ratio stems from the investment-driven debt increase and the expected reduction of the operating balance in the medium term, due to continued inflationary pressure and the constant changes to the LRGs' funding system introduced by the Polish Deal reform in 2022.

Fitch's rating case projects that the fiscal debt burden will increase to 38% in 2028 from 25% in 2023. We expect the city's synthetic debt service coverage ratio to weaken to an average 1.3x during 2024-2028, from a strong five-year average of 4.6x. However, all of the ratios result in an unchanged overall debt sustainability assessment at 'aa'.

We expect the operating balance to deteriorate to PLN215 million on average in 2024-2028 from almost PLN300million average in 2019-2023, mainly due to inflationary increases of goods and services, as well as growth pressure on salaries driven by increasing minimum wages, among other things. The level of revenue from income taxes is determined by Ministry of Finance forecasts, and the share of income taxes is distributed to LRGs in 12 equal instalments.

We expect the city to incur capex of almost PLN3 billion in 2024-2028. The robust investment plan will lead to budgetary deficits on average 4% in 2024-2028 (2023: 6.2%), with a peak of 7.6% in 2024. Gdansk will continue to prioritise investments for which it can obtain external non-returnable financing. Despite its sizable capex, the city has been able to maintain its debt over the past five years at a stable PLN1 billion. We expect direct debt to grow over our rating case to just below PLN2 billion by end-2028, due to high capex and a lower operating balance resulting from increasing spending.

DERIVATION SUMMARY

Fitch assesses Gdansk's Standalone Credit Profile (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): 'N/A'

Rating Cap (LT LC IDR) 'N/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 2019-2023 figures and 2024-2028 projected ratios. The key assumptions for the scenario include:

- Annual average 4.5% increase in operating revenue, including tax revenue CAGR 7.5% and transfers received CAGR 3.4%, driven by the anticipated rebound of the Polish economy.

- Annual average 4.5% increase in operating spending; due to inflationary increases of municipal services provision costs, as well as growth pressure on salaries driven by increased minimum wages.

- Net capex PLN318 million on average, lower than PLN355 million in 2019-2023, as the city's investments are yet to pick up pace.

- Average cost of debt increasing to 5.3% annually in 2024-2028 from 2.3% in 2019-2023, due to higher policy rates.

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 760,748 inhabitants (source: Central Statistical Office in Poland). The conurbation's gross regional product per capita was above PLN103,800 in 2023 and exceeded the national by almost 50%. Unlike the majority of Polish cities, Gdansk's population has been growing (486,492 at mid-2023 vs. 463,726 end 2016), due to positive net migration compensating for the negative birth rate.

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 or a downward revision of the city's SCP, which could be driven by a deterioration in debt metrics, particularly debt payback rising above 9x on a sustained basis under Fitch's rating case would be rating negative.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

A debt payback ratio remaining lower than or equal to 7.5x on a sustained basis under Fitch's rating case could lead to an upgrade, provided the sovereign was also upgraded, as the city's IDRs are equalised with 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: 12 March 2024

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.

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 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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PARTICIPATION STATUS

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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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