FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Polish City of Katowice at 'BBB+'; Outlook Stable

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Fitch Ratings - Warsaw - 28 Apr 2023: Fitch Ratings has affirmed the Polish City of Katowice's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB+'. The Outlooks are Stable. A full list of rating actions is below.

The affirmation reflects Fitch's view that the city's operating performance and debt ratios will remain in line with 'BBB+' peers over the medium term. This is 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 Katowice's Standalone Credit Profile (SCP) at 'bbb+', which results from a 'Midrange' risk profile and 'a' debt sustainability. The city's IDRs are not affected by any other rating factors, and are equal to the SCP.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Fitch assesses Katowice's risk profile as 'Midrange', in line with other Fitch-rated Polish cities. The assessment reflects Fitch's view that there is a moderately low risk of the issuer's ability to cover debt service with the operating balance weakening unexpectedly over the scenario horizon (2023-2027) due to lower revenue, higher expenditure, or an unexpected rise in liabilities or debt-service requirements.

The risk profile combines our assessment of one 'Weaker' (revenue adjustability) key risk factor, one 'Stronger' (expenditure adjustability) key risk factor and four others 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, should help support revenue stability.

Tax revenue accounted for over 47% of Katowice'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 36% of operating revenue in 2022, the majority of which was transfers from the Polish state budget. The majority of these transfers are defined by law.

Revenue Adjustability: 'Weaker'

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

Expenditure Sustainability: 'Midrange'

The Polish Deal reform does not affect municipalities' expenditure 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 (16.1% inflation in March 2023), pressurising the cost of goods and services (26% of operating spending) and wages, which are inflexible and accounted for 32% 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'

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Stronger'. The city's mandatory responsibilities account for about 60% of total expenditure. Compared with other Polish cities, Katowice has always spent higher amounts to provide citizens with a high standard of services (the city spent on average 30% more than urban counties with the lowest spending per capita over the last three years). Fitch assumes that Katowice could reduce operating expenditure by at least 10% in case of need, as it did partially in 2021.

It also has scope to scale back capex, which represents a high share of total spending (18% on average in the past 10 years). In 2022, Katowice's capex was just below PLN440 million or about 16.3% of total expenditure.

Liabilities & Liquidity Robustness: 'Midrange'

Katowice's loan portfolio is dominated by loans from international financial institutions (94% at end-2022). This provides the city with a long-term and smooth repayment schedule, with final debt maturity in 2043.

Almost all of the city's debt has floating interest rates, which exposes it to interest-rate risk as Polish cities are not allowed to use derivatives for hedging. Of its outstanding debt at end-2022, 7.9% was in euros. This share will decrease gradually as the city does not plan to incur new debt in foreign currency. The city somewhat mitigates interest-rate and FX risk by prudently setting aside more funds than is necessary for debt service.

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, Katowice has a long record of healthy liquidity. The city has a committed but unused credit line of PLN50 million with a large domestic bank.

Katowice has still PLN50 million available under a loan agreement with European Investment Bank (AAA/Stable) to finance investments. The city plans to draw the full facility until end-2023, in line with its investment needs.

Debt Sustainability: 'a category'

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 for Katowice, although they will remain commensurate with the current 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 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 in debt, which will erode the debt payback (primary metric of debt sustainability for type B LRGs; net adjusted debt-to-operating balance) to above 9,9x on average (2022: 2.6x) 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 31% before improving to 28% in 2027.The synthetic debt service coverage ratio remains at 1.1x on average throughout 2024-2027 in our rating case. All these metrics result in an overall debt sustainability assessment at the upper end of the 'a' category.

Katowice's operating balance, although inflated by the additional PIT revenue received in 2022 (PLN79 million), declined to PLN182 million in 2022, or 7.6% of operating revenue, from PLN197 million in 2021 (both values adjusted for the additional subsidy of PLN69 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 PLN34 million, as the city received compensation for lower PIT revenue in 2023 in 2022, before it rebounds to an average of around PLN80 million, which will still be just below 43% of the last five years' average of PLN 184million.

Under our rating case, 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 above 11% of total revenue under our rating case. We expect Katowice's adjusted debt to increase to above PLN980 million at end-2024 from PLN822 million at end-2022, following the current investment plan, which is significantly reduced in the final years of the rating horizon compared with 2018-2023. Potential new capex will depend on the city's self-financing capacity and the availability of funds under the 2021-2027 EU budget and the New Generation Fund.

DERIVATION SUMMARY

Fitch assesses Katowice's SCP at 'bbb+', which results from a Midrange assessment of the city's risk profile and 'a' assessment of debt sustainability, stemming from a payback ratio in the upper end of the 'a' category and moderate debt level corresponding with the 'aaa' category. The weaker synthetic debt coverage is less meaningful, as it does not incorporate the long-term maturity profile of the city's debt (20 years) and high interest revenue. Katowice's SCP 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, and are equal to the SCP.

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: 'a'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap (LT IDR): 'N/A'

Sovereign Cap (LT LC IDR) 'N/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 2.4% increase in operating revenue, including tax revenue CAGR 4.9% and transfers received CAGR 0.2%;

- Annual average 3.6% increase in operating spending;

- Net capex PLN110 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

Katowice is a medium-sized city, classified by Fitch as a 'Type B' LRG as it is required to cover debt service from cash flow on an annual basis. It has a population of just above 282,000 located in the Slaskie region and the region's capital. The local economy, in terms of gross value added in 2019, is dominated by services. Its unemployment rate of 1.4% at end-2022 (2021: 1.8%) was one of the lowest among Polish cities (5.2% national average). The city's average salary at end-2022 was PLN7,709, 16% higher than the national average (PLN6,653).

RATING SENSITIVITIES

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

A downward revision of the city's SCP, which could be driven by deterioration in debt metrics, particularly debt payback rising above 10.5x 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 than or equal to 9x on a sustained basis under Fitch's rating case.

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

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
Katowice, City of	LT IDR	BBB+ Rating Outlook Stable Affirmed	BBB+ Rating Outlook Stable
	LC LT IDR	BBB+ Rating Outlook Stable Affirmed	BBB+ Rating Outlook Stable

	Natl LT AA+(pol) Rating Outlook Stable Affirmed	AA+ (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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Katowice, City of	EU Issued, UK Endorsed

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