FitchRatings

RATING ACTION COMMENTARY

Fitch Maintains Polish City of Katowice on Rating Watch Negative

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Fitch Ratings - Warsaw - 06 May 2022: Fitch Ratings has maintained the Polish City of Katowice's 'A-' Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) and 'AA+(pol)' National Long-Term Rating on Rating Watch Negative (RWN). A full list of rating actions is below.

The RWN reflects continuing uncertainty about the financial impact of the 'Polish Deal' fiscal reform on Katowice'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%, with effect from 1 July 2022. The envisaged changes will significantly affect the Polish municipalities' funding system, further reducing their tax revenue from levels initially estimated when the tax reform was first announced. For Katowice we will need to review our scenario analysis as it may lead to a change in the financial profile and 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 revenue 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 widen the gap between the drop in revenue and the compensation from the state budget, as details of the law are currently unknown. Municipalities will be forced to implement measures, such as increasing local taxes and fees and reducing 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 our six key risk to be affected by the 'Polish Deal' tax reform. Katowice's 'Midrange' risk profile reflects a combined assessment of four 'Midrange' key factors (revenue robustness, expenditure sustainability and liabilities, and liquidity flexibility and robustness), one 'Stronger' (expenditure adjustability) and another 'Weaker' (revenue adjustability).

The assessment reflects Fitch's view of a reasonably low risk that Katowice's debt service coverage by the operating balance will weaken unexpectedly over the forecast horizon (2021-2025), either because of lower-than-expected revenue or higher-than-expected spending, or an unanticipated rise in liabilities/debt-service requirements.

Revenue Robustness: 'Midrange'

The city has a proven record of operating revenue growth, with a CAGR of 6.2% in 2017-2021, underpinned by higher GDP per capita and low unemployment. Operating revenue is mostly made up of taxes (almost 50% of operating revenue in 2021), such as personal income tax (PIT; almost 29%) as well as local taxes mainly property tax (14%) and corporate income tax (CIT), also the most volatile revenue item, (below 6%).

Following the 'Polish Deal' reform, the city at end-2021 received PLN69.4 million in extra subsidies from the state as partial compensation for the expected PIT decline in 2022. We have adjusted the city's extra subsidies by withdrawing them from 2021 and adding them back in 2022 to avoid distorting the city's operating balance trend.

Current transfers accounted for almost 35% in 2021 (when excluding the additional subsidies), down from 38% in 2020, with the majority being 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. Fitch expects Katowice, whose economy is strongly driven by services, to remain attractive to investors and inhabitants.

Revenue Adjustability: 'Weaker'

We assess Katowice's ability to generate additional revenue in response to possible economic downturns as 'Weaker'. This is in line with our assessment for the majority of Polish cities rated by Fitch. Income tax rates are set by the central government and current transfers decided by the state. Katowice has limited flexibility on local taxes (14% of operating revenue), as the rates are constrained by ceilings set in national tax regulation. In our view, additional revenue using discretionary tax leeway would not cover 50% of a reasonably expected decline of revenue in an economic downturn.

The city could increase its revenue with active asset sale (2021: PLN58 million) or higher dividends from municipal companies (2021: PLN5.5 million). However, this source of revenue may prove unsustainable in a prolonged economic downturn.

Expenditure Sustainability: 'Midrange'

Katowice's 'Midrange' expenditure sustainability is in line with the majority of Polish cities'. The city's main responsibilities are non-cyclical, including education, public transport, municipal services, administration, housing, culture, sport, as well as public safety and family benefits that are mandated by the central government and financed from the central budget.

Historically, Katowice's operating expenditure growth has been in line with revenue growth. However, the operating margin had been on a downtrend since 2016 (14%), mainly due to state-mandated additional spending (eg increases in minimum wages and teachers' salaries) and accelerating goods and services inflation, and in 2020, also due to costs for Covid-19 measures. The operating margin rebounded to 8.7% in 2021 after bottoming out at 7% in 2020.

We expect the city's capex to remain high in 2022, leading to a budget deficit above 10% of total revenue.

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 and compared with other Polish cities, Katowice always spent higher amounts to provide citizens with a high standard of services (the city spent on average 30% over the last three years, more than urban counties with the lowest spending per capita). 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 (20% on average in the past 10 years). In 2021, Katowice 's capex was PLN377 million or about 15% of total expenditure.

Liabilities & Liquidity Robustness: 'Midrange'

National regulations for Polish LRG debt and liquidity are moderate. Katowice's loan portfolio is dominated by loans from international financial institutions (95% at end-2021). This provides the city with a long-term and smooth repayment schedule, with final debt maturity in 2043.

All its debt has floating interest rates, which exposes the city to interest-rate risk as Polish cities are not allowed to use derivatives for hedging. Of its outstanding debt at end-2021, 8.4% was in euros and this share will decrease gradually as the city does not plan to incur new debt in foreign currency. The city partially mitigates these risks by prudently setting aside more funds than is necessary for debt service.

Katowice's indirect risk is low and its net adjusted debt comprises payments to a sport and event hall operator (2021: PLN71 million), which we treat as other Fitch-classified debt; the debt of municipal companies (2021: PLN181 million, excluding guaranteed debt), which is self-funded; and guarantees issued to the city's social housing company (2021: PLN3 million). As the city does not plan to issue further guarantees we expect guarantees and the debt of municipal companies to gradually decrease, all else being equal.

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 an unused credit line of PLN50 million with a large domestic bank.

Cash at the city's bank accounts at end-2021 adjusted for the one-off subsidy was PLN501 million and included PLN48 million of restricted cash, mainly relating to the Governmental Local Investment Fund, a state imposed anti-Covid-19 measure, which can be spent on investments only (in 2022). Average cash balances in 2021 (PLN572 million) exceeded the pre-Covid-19 levels (2019: PLN482 million), which is a positive rating factor.

Katowice has still PLN104 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: '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 affect Katowice'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 profile. 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 Katowice's preliminary results for 2021 with our base- and rating-case scenarios made in 2021, the city has outperformed our expectations. The preliminary operating balance was PLN197 million, when excluding the additional subsidies of PLN69.4 million, versus PLN165 million and PLN160 million in the base- and rating-case scenarios respectively. Net adjusted debt amounted to PLN416 million, which was also below our expectations (PLN525 million and PLN534 million, respectively).

We continue to maintain 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 an 'aa' DS score and the weaker synthetic debt service coverage ratio at an '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 overall DS assessment at 'aa'.

DERIVATION SUMMARY

In our last rating action on 28 May 2021, Fitch had assessed Katowice's SCP at 'a-', which resulted from a 'Midrange' risk profile and 'aa' DS. The city's SCP reflects comparison with peers in the same rating category. Fitch may revise down the SCP, depending on the ultimate impact of the 'Polish Deal'. The city's IDRs are not affected by any other rating factors, and are equal to 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: '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 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- On average 3.5 % yoy increase in operating revenue

- On average 4.2% yoy increase in operating spending

- Negative net capital balance on average at PLN204 million

- Average cost at 1.6% p.a. and up to 20-year maturity for new debt

- Municipal companies to repay existing debt and no new guarantees

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for 2021 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 the one-off subsidies resulting from the 'Polish Deal' paid in December 2021 for cost coverage in 2022 by withdrawing them from current transfer in 2021 and adding them back in 2022.

Issuer Profile

Katowice is a medium-sized city with a population of close to 300,000 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. It's unemployment rate of 1.8% at end-2021 (2020: 1.7%) was one of the lowest among Polish cities (5.4% national average). The city's average salary at end-2019 was PLN6,176, 19% higher than the national average (PLN5,182).

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, if the expected revenue decline is not compensated by Katowice's countermeasures, 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.

A downgrade of Poland's sovereign ratings would lead to downgrade of the city's ratings.

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

The RWN could be removed and the ratings affirmed if Katowice's DS and SCP are unaffected after considering all measures implemented to counteract the expected fall in PIT revenue.

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	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	AA+(pol) Rating Watch Negative Rating Watch Maintained	AA+ (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

Katowice, City of	EU Issued, UK Endorsed

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