FitchRatings

RATING ACTION COMMENTARY

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

Fri 26 Apr, 2024 - 5:12 PM ET

Fitch Ratings - Warsaw - 26 Apr 2024: Fitch Ratings has affirmed the Polish City of Katowice's 'BBB+' Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs). 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+' rated peers over the medium term, despite weaker operating performance in 2023. This was due to lower personal income tax (PIT) revenue stemming from the recent tax reform and the expenditure increases driven mainly by salary pressures.

We forecast a gradual improvement of the payback ratio in the medium term, despite continued high investment expenditure requiring debt finance, coupled with ongoing challenges of managing rising opex. However, Fitch assumes that the current funding system of local and regional governments (LRGs) in Poland is unchanged.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

This assessment is in line with majority of 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.

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'

This assessment reflects our 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 Katowice's operating revenue in 2023, and is based on moderately cyclical economic activities.

PIT accounted for almost 22% of operating revenue, followed by local taxes at more than 16% and corporate income tax (CIT), a more volatile revenue item, at just above 8%. Current transfers accounted for over 34% 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 is defined by law.

Revenue Adjustability: 'Weaker'

This assessment reflects Katowice's limited ability to generate additional revenue. It is in line with our assessment for majority of Fitch-rated Polish LRG, as income tax rates and current transfers are set by the central government, which significantly limits LRGs' flexibility to increase revenue. Katowice has also limited flexibility on local taxes, as rates are constrained by ceilings set within national tax regulation.

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, 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 and not affected by tax relief 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'

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. The still-elevated inflation rate, which stood at 6.2% yoy at end-2023, continues to impact the cost of energy, as well as the cost of services acquired by the city.

Personnel expenses constituted an average of 32% of totex (10 year average) and we expect them to continue to increase due to the hikes in the minimum wage and the central government's decision to increase the teachers' salaries. This surge in expenditure will continue strain the city's financial operations and make its attempts to improve operating margins challenging.

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 has spent higher amounts to provide citizens with a high standard of services (the city spent on average 30% more over the last three years than urban counties with the lowest spending per capita). It also has scope to scale back capex, 18% of total spending (last 10-year average). In 2023, Katowice 's capex was PLN949 million or 28% of total expenditure.

Liabilities & Liquidity Robustness: 'Midrange'

Katowice's loan portfolio is dominated by loans from international financial institutions (87% at end-2023). This provides the city with a long-term and smooth repayment schedule, with final debt maturity in 2045. As of end-2023, fixed-rate obligations constituted 34% of the city's debt composition. However, this debt is scheduled for re-fixing of interest rates in 2025 and 2027, 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.

Of its outstanding debt at end-2023, 5.5% was euro-denominated. This share will gradually decrease as the city does not plan to incur new debt in foreign currency. The city mitigates interest-rate and FX risk by prudently setting aside more funds than necessary for debt service, and currently also by higher interest revenue from deposits (2023: PLN16 million). Indirect risk stemming from the city's shareholdings is low relative to the 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, 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.

Debt Sustainability: 'a category'

Under its rating case for 2024-2028, Fitch projects the city's payback ratio will remain elevated in 2024 at 20.4x (2023: 20.9x) before it returns to around 10x in 2025-2028. The near-term weaker payback stems from the investment-driven debt increase and the expected low, albeit improving operating balance.

We expect the city's fiscal debt burden ratio to remain strong at below 60% (2023: 34.2%), counterbalancing weaker synthetic debt service coverage of around 1.1x (2023: 0.5x). However, this does not factor in high interest revenue and the ratio being calculated based on a 15-year maturity, whereas the city debt has original maturities up to 25 years.

We expect the operating balance to gradually rebound to PLN160 million on average in 2025-2028 from only PLN40 million 2023, mainly due to easing of inflationary pressures on goods and services, as well as management's efforts on spending rationalisation.

We expect the city to incur capex of almost PLN2.8 billion in 2024-2028. The robust investment plan will lead to budgetary deficits on average 8.7% in 2024-2026 (2023: 12.7%). The city's capex is linked to the availability of non-returnable grants, and Katowice will continue to prioritise investments for which it can obtain external non-returnable financing.

DERIVATION SUMMARY

Fitch assesses Katowice's Standalone Credit Profile (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 better end of the 'a' category and moderate debt level corresponding with the 'aa' 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.

National Ratings

Katowice's National Rating of 'AA+(pol)' is the higher option possible under Fitch's National Rating scale equivalent to its Long-Term Local-Currency IDR of 'BBB+'.

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'

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 6.0% increase in operating revenue, including tax revenue CAGR 7.0% and transfers received CAGR 4.9%, driven by the anticipated rebound of the Polish economy.

- Annual average 5.1% increase in operating spending; due to continued inflationary increases of municipal services provision costs, as well as growth pressure on salaries driven by increased minimum wages.

- Net capex PLN276million on average, above PLN260 million in 2019-2023, as the city's investments under the new EU programming period are picking up pace.

- Average cost of debt increasing to 5.2% annually in 2024-2028 from 2.7% in 2019-2023, due to higher policy rates.

- The proposed changes to the LRG income Act are not taken under consideration, due to their initial stage

Liquidity and Debt Structure

Katowice's direct debt was PLN878 million at end-2023, up from PLN758 million at end-2022 as the city drew down its available EIB loan (PLN95 million) and issued bonds (PLN80 million) to finance investments. Net adjusted debt corresponds to the difference between adjusted debt and the year-end available cash viewed as "unrestricted" by Fitch (PLN121 million at end-2023).

The city's net adjusted debt was PLN832 million at end-2023 (2022: PLN475 million) due to new debt, and a lower cash balance than in 2022, as it was used for expenditure, including its large capex.

Issuer Profile

Katowice, a medium-sized city nestled in Poland's industrially rich Upper Silesian region. Fitch views it as as a 'Type B' LRG, signifying its obligation to annually cover debt service from own cash flow.

Despite a national trend of population decline, Katowice's economy shows resilience with an unemployment rate of just 1.0% and an average salary 16% higher than the national average. The city's economic landscape is dominated by a robust service sector, which generated over 74% of gross value added in 2021, and is complemented by strong traditional industries such as chemicals and mining.

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

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: 23 April 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
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

FITCH RATINGS ANALYSTS

Maurycy Michalski
Director
Primary Rating Analyst
+48 22 103 3027
maurycy.michalski@fitchratings.com
Fitch Ratings Ireland Limited spolka z ograniczona odpowiedzialnoscia oddzial w Polsce
Marszalkowska 107, 00-110 Warsaw

Dorota Dziedzic
Senior Director
Secondary Rating Analyst
+48 22 103 3017
dorota.dziedzic@fitchratings.com

Chiaramaria Mozzi
Senior Director
Committee Chairperson
+39 02 9475 7264
chiaramaria.mozzi@fitchratings.com

MEDIA CONTACTS

Athos Larkou
London
+44 20 3530 1549
athos.larkou@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

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

Katowice, City of	EU Issued, UK Endorsed

DISCLAIMER & DISCLOSURES

All Fitch Ratings (Fitch) credit ratings are subject to certain limitations and disclaimers. Please read these limitations and disclaimers by following this link: https://www.fitchratings.com/understandingcreditratings. In addition, the following https://www.fitchratings.com/rating-definitions-document details Fitch's rating definitions for each rating scale and rating categories, including definitions relating to default. ESMA and the FCA are required to publish historical default rates in a central repository in accordance with Articles 11(2) of Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 and The Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019 respectively.

Published ratings, criteria, and methodologies are available from this site at all times. Fitch's code of conduct, confidentiality, conflicts of interest, affiliate firewall, compliance, and other relevant policies and procedures are also available from the Code of Conduct section of this site. Directors and shareholders' relevant interests are available at https://www.fitchratings.com/site/regulatory. Fitch may have provided another permissible or ancillary service to the rated entity or its related third parties. Details of permissible or ancillary service(s) for which the lead analyst is based in an ESMA- or FCA-registered Fitch Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed. Fitch Ratings makes routine, commonly-accepted adjustments to reported financial data in accordance with the relevant criteria and/or industry standards to provide financial metric consistency for entities in the same sector or asset class.

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. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch’s website.

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the “NRSRO”). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the “non-NRSROs”) and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

dv01, a Fitch Solutions company, and an affiliate of Fitch Ratings, may from time to time serve as loan data agent on certain structured finance transactions rated by Fitch Ratings.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained by Fitch at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.