

Fitch Affirms Polish City of Kielce at 'BBB'

Fitch Ratings, Warsaw/ London, 29 September 2017: Fitch Ratings has affirmed the Polish City of Kielce's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB' and National Long-Term Rating at 'A+(pol)'. The Outlooks are Stable.

The affirmation reflects Fitch's unchanged base case scenario for the city's satisfactory operating performance and sound debt ratios for the ratings, in line with 'BBB' peers, supported by robust management and a growing national economy. The ratings further factor in the modest local economy as well as budget size, which makes it sensitive to negative changes in economic trends or institutional framework.

KEY RATING DRIVERS

We expect Kielce to maintain a satisfactory operating performance with an operating margin at around 6%-7% and an operating balance generally sufficient to cover annual debt service. The debt-to-current balance ratio should remain at around 15-16 years, and direct debt around 70% of current revenue, despite its expected growth following investments.

In 1H17 Kielce reported operating balance of about PLN46 million, below PLN73 million in 1H16. We expect the full-year operating results to stabilise than to improve in comparison with 2016 due to rising opex pressure, especially on education resulting from state reform, and on salaries following the general market trend of declining unemployment and rising salaries in the private sector. In 2016 Kielce reported a satisfactory operating balance of PLN69 million, which translates into an operating margin of 6.5%

In 1H17 Kielce posted a budgetary surplus of PLN21 million, although the city budgeted a large budgetary deficit of PLN135 million or 7% of total revenue. The surplus stems from the lower pace of launching EU capex programmes than the city expected at the beginning of the year. We expect that significant part of investments will be shifted from 2017 to 2018, so actual capex may be 60% of the amount budgeted by the city. As a result we expect a deficit of around 3% of total revenue in 2017 and 4%-5% of total revenue in 2018-2019 when the investment process will accelerate.

We expect the investment process to accelerate from 2018 as the city will conduct investments co-financed from the EU funds available for Polish local governments. We expect capex of PLN200 million-PLN230 million per year, half of which will be financed from capital revenue (mainly EU grants), the current balance and new debt. Fitch assumes that Kielce's direct debt will gradually grow in 2017-2019 as a result of financing infrastructure investment. However, we expect that it will remain moderate at around 70% of current revenue (2016: PLN705 million or 66% of current revenue).

Almost all of Kielce's direct debt is floating rate, which exposes the city to interest rate risk. However, this is mitigated by the city's prudent budgetary approach, whereby the city usually budgets higher interest payments on debt than the actual amounts paid. The city is not exposed to foreign-currency risk, as all of Kielce's debt is local currency denominated.

Operating balances reported by Kielce are usually sufficient to meet its annual debt service (both interests and instalments). However, this relationship can be disrupted in years when the city is making earlier debt redemption to restructure its debt profile. In 2016 Kielce repaid more of its direct debt than budgeted at the beginning of the year -- PLN67.5 million versus PLN39 million. This influenced the debt service to operating balance ratio, which would have been 82% instead of 123%. In 2017 the city plans to repay PLN35 million above the schedule of most expensive loans, so the debt service ratio will again be above 100%.

Like many other Polish subnationals, Kielce faces pressure on operating expenditure. Much of the operating expenditure pressure arises from under-funded responsibilities that were transferred to local governments by the state in the past and from the dominance of rigid spending items such as education and social care. To counteract this pressure Kielce's administration is monitoring spending on employment, organising collective tenders for utilities and modernising public buildings.

Kielce is a medium-sized city in Poland with around 200.000 inhabitants. Kielce's economy is diversified but is weaker than other cities that are also capitals of their respective region. GDP per capita in 2014 (latest available data) for the Kielecki sub-region, which includes Kielce and surrounding villages, was 79% of the national average. We estimate the city's wealth indicators are on a par with the national average, as Kielce is the strongest area in the sub-region.

RATING SENSITIVITIES

The ratings could be upgraded if city improves its operating margin toward 10% and maintains a moderate debt level.

A downgrade could result from deterioration in operating performance, with a direct debt to current balance deteriorating above 15 years on a sustained basis or a significant increase in net overall risk to above 100% of current revenue.

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Applicable Criteria

[International Local and Regional Governments Rating Criteria - Outside the United States \(pub. 18 Apr 2016\)](#)

[National Scale Ratings Criteria \(pub. 07 Mar 2017\)](#)

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