FitchRatings

Fitch Revises City of Kielce's Outlook to Negative; Affirms at 'BBB'

Link to Fitch Ratings' Report(s): City of Kielce - Rating Action Report

Fitch Ratings-Warsaw/London-15 March 2019: Fitch Ratings has revised the City of Kielce's Outlook to Negative from Stable and affirmed the city's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB' and National Long-Term Rating at 'A+(pol)'.

The Outlook reflects uncertainty over the ability of the city's authorities to successfully implement the intended cost-rationalisation and cost-saving measures and improve Kielce's operating results. This follows significant deterioration to operating performance in 2018 when the city's operating balance and debt payback ratio were below Fitch's expectations.

The ratings take into account the projected growth of the city's tax revenue following economic expansion, and EU grants on capital expenditure, which somewhat ease the city's debt needs. The ratings also take into consideration the pressure on the city's operating expenditure and an expected rise in debt, although it should still remain moderate in the medium term.

KEY RATING DRIVERS
Fiscal Performance: Neutral/ Negative
Fitch rating case expects Kielce's operating results to improve in the medium term, reflecting the impact of cost control and efficiency improvement measures. The city's operating results will also be supported by tax revenue increase, on projected growth of the national economy and also the city's decision to increase local taxes and fees.

Fitch rating case envisages the city's operating balance to gradually improve by about PLN10 million annually over the next three years, to reach PLN90 million in 2021 and PLN100 million in 2022. This will be sufficient to fully cover debt service (debt repayments plus interest paid) and keep debt-to-current balance below 15 years.

However, it is uncertain if the city will be able to successfully implement cost savings and efficiency measures in order to accommodate additional operating spending pressure over the medium term. If unsuccessful Kielce may face higher debt needs, especially in light of its planned significant investments, which would result in debt service ratios being out of line with the current rating, leading to a downgrade.

In 2018 Kielce's operating balance was rather weak for the ratings and below our expectations, at PLN48 million or just 4.1% of operating revenue (2017: PLN62 million or 5.5%). As a result the operating balance was insufficient to meet the city's annual debt service of PLN55 million (both interest and instalments). The debt payback ratio (debt-to-current balance) deteriorated to around 29 years in 2018, from 17.4 years in 2017 and about 18 years projected by Fitch.

Our rating case envisages that Kielce will continue to implement investments to take advantage of non-returnable EU grants. In Fitch's view the city's capital expenditure may average PLN220 million annually in 2019-2022 (or 15% of total expenditure), with about 50% being financed from EU grants. Given that the operating balance is expected to gradually improve its share in financing capex should rise to above 40% in three years from less than 15% estimated for 2019, reducing the need for debt financing.

Debt: Neutral/Stable
Fitch projects that Kielce's debt will grow by about PLN65 million per year in 2019-2021 on investments, but the debt level should not exceed PLN1,050 million or 80% of current revenue in 2021 (at end-2018 debt was PLN842 million or 71% of current revenue).

Due to the projected recovery of operating results the debt payback ratio should gradually improve to about 20 years in 2020-2021 and further to about 12 years in 2022, which will be consistent with the ratings and more in line with the city's average debt maturity of about 10 years.

The strengthening operating results should enable the city authorities to meet rising debt service from 2022 and remain in compliance with the individual debt limit set by law. Debt service will rise to almost PLN100 million in 2023 from about PLN55 million in 2018, due to higher debt repayments (above PLN70 million in 2023 from PLN35 million in 2018) and expected increases in interest rates in Poland.

Management: Neutral/Stable
Local elections in November 2018 led to the appointment of the city's new president, Bogdan Wenta, over a five-year-term. A new treasurer was also appointed in March 2019.

The city authorities' priority is to create a favourable living and business environment to attract investments and facilitate close cooperation between companies and the higher education sector for the training of future staff. The city authorities are striving to increase efficiency in the delivery of its services, to reduce costs of services while maintaining quality. The city authorities aim to further improve the city's infrastructure, using available EU grants.

Rising operating spending pressure in the subnational sector in Poland, especially on education, salaries and basic municipal services, will test the city authorities' ability to successfully implement their priorities.

Economy: Neutral/ Stable
Fitch expects Kielce's tax revenue growth to be supported by Poland's GDP growth, which the agency forecasts at about 3% annually in the medium term. Kielce's economy is diversified but is weaker than other cities that are also capitals of their respective regions. GDP per capita in 2016 (latest available data) for the Kielecki sub-region, which includes Kielce and surrounding villages, was 78.2% 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. Kielce is a medium-sized city in Poland with around 200.000 inhabitants.

Institutional Framework: Neutral/Stable
Fitch assesses the regulatory regime for Polish local and regional governments (LRGs) as neutral. LRGs' activities and financial statements are closely monitored and reviewed by the central administration. Disclosure in the LRGs' accounts is more than adequate. The main revenue sources such as income tax revenue, transfers and subsidies from the central government are centrally distributed according to a legally defined formula, which limits the central government's scope for discretion.

RATING SENSITIVITIES
A failure to improve the debt-current balance ratio below 15 years on a sustained basis or a significant increase in net overall risk to above 100% of current revenue could lead to a downgrade.

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