13 Sep 2019 | Affirmation

Fitch Affirms Polish City of Kielce at 'BBB'; Outlook Negative

Fitch Ratings-Warsaw-13 September 2019:

Fitch Ratings has affirmed the Polish City of Kielce's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB'. The Outlooks are Negative.

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

Kielce is a medium-sized city in Poland with around 200.000 inhabitants. It is the capital of Swietokrzyskie region. Kielce's economy is diversified but is weaker than that of other cities that are also capitals of their respective regions.

Key Rating Drivers

Revenue Robustness Assessed as Midrange

Kielce has a track record of operating revenue growth outpacing nominal national GDP growth, but our assessment is constrained by its low wealth indicators by international standards with a per-capita GDP about 30% below EU level. The city's revenue sources are stable as current transfers account for 46% of operating revenue, with the majority from the state budget (A-/Stable) as defined by law. Tax revenue accounts for 37% of Kielce's operating revenue, the majority of which is not particularly dependent on economic cycles, while corporate income tax, a more volatile revenue item, accounts for only 1.5% of tax revenue.

Revenue Adjustability Assessed as Weaker

We assess Kielce's ability to generate additional revenue in response to economic downturns as limited, in line with the majority of Polish cities. Income tax rates and the majority of current transfers are set by the central government. Kielce has little flexibility on local taxes (13% of operating revenue), which are constrained by the ceilings set in national tax regulation.

Expenditure Sustainability Assessed as Midrange

The city's expenditure sustainability is underpinned by non-cyclical responsibilities such as education, public transport, municipal services, and administration.

Kielce had exhibited a track record of moderate control of operating expenditure growth, until the last two years, ahead of the local elections held in November 2018, when operating spending increase outpaced operating revenue growth. This led to a weak operating balance of PLN49 million ie. 4.1% of operating revenue (on average PLN70 million or 7.3% in 2014-2016). The coming months will test the city authorities' ability to successfully implement the city's cost-rationalisation and cost-saving measures and thus to improve operating results.

We expect the city's capex to remain high in 2019-2022, averaging PLN220 million annually ie. 15% of total expenditure, driven by EU co-financed investments. This will lead to average budget deficits of 4% of total revenue until 2022 before improving to a balanced budget.

Expenditure Adjustability Assessed as Midrange

Kielce's ability to reduce spending in response to shrinking revenue is primarily based on capex (on average 18% of total in 2014-2018), which could be significantly reduced, and on operating expenditure, 10% of which is discretionary. The city's planned PLN950 million capex over the next five years consists of a large number of small and medium-sized projects, many of which could be scaled down, postponed or abandoned in case of need.

Mandatory responsibilities account for 73% of operating spending, including education, social care, administration, public safety and family benefits. The city has higher spending flexibility in respect to other sectors, including public transport, culture, sport, healthcare and housing economy.

Liabilities and Liquidity Robustness Assessed as Midrange

Debt service limits mandate Polish local and regional governments (LRGs) to match debt servicing requirements with operating balance and require borrowing with a linear amortising repayment structure. Kielce's debt is fully zloty-denominated, with a 11% share of European Investment Bank (AAA/Stable, undrawn PLN160 million still available for capex financing). Following a successful extension of debt maturities coming due in the next six years debt repayments over the next three years are modest (PLN36 million in 2019 and about PLN20 million each in 2020 and 2021). The figure will gradually rise to about PLN100 million annually in 2024-2026, but its projected operating balance should be sufficient to cover this high debt service in those years.

The city is exposed to interest rate risk as Polish cities are not allowed to use derivatives while most of the debt is in floating rates. However, this is mitigated by a developed national financial market and the city's prudent budget practice, including budgeting for higher-than-necessary debt service amounts.

Liabilities and Liquidity Framework Flexibility Assessed as Midrange

Fitch assesses the city's liquidity framework as 'Midrange' given the lack of emergency liquidity support from upper tiers of government and liquidity available under a committed liquidity line (with a limit of PLN50 million) provided by ING Bank. Kielce frequently uses this liquidity to manage its liquidity during the year and to avert drawing down more costly long-term debt closer to year-end. This policy results in low levels of cash at year-end (averaging PLN30 million annually in 2014-2018).

Due to low debt repayments over the next three years, our rating scenario projects a liquidity coverage ratio (operating balance plus unrestricted cash-to-debt service in current year) of 1.5x on average in 2019-2023, in line with that in 2015-2018.

Fitch assesses Kielce's risk profile as 'Midrange' based on its 'Midrange' assessment of five key factors and one 'Weaker' key factor outlined above, with less weight being placed on the latter in the overall assessment.

Debt Sustainability Assessment: 'a'

Under its rating case for 2019-2023, Fitch projects the city's debt payback ratio (net adjusted debt-to-operating balance), to improve to about 10.1x in 2023 from 16.8x in 2018, thus more in line with a 'a' assessment rather than a 'bbb' assessment when based solely on 2018 results. The city's fiscal debt burden will remain strong during the forecast period, at no more than 80% (69% in 2018). The strong fiscal debt burden ratio counterbalances the city's weak synthetic and actual debt service coverage ratios of 1.1x and 0.9x, respectively. All these metrics result in a 'a' debt sustainability assessment.

Derivation Summary

Fitch assesses Kielce's standalone credit profile (SCP) at 'bbb', which reflects a 'Midrange' risk profile, or a low risk of shrinking operating cash-flow and/or debt servicing requirement exceeding our expectations, and 'a' debt sustainability assessment. The city's final IDRs are not affected by any asymmetric risk or extraordinary support from the Polish state.

Key Assumptions

Fitch's key assumptions within our rating case for the issuer include:

- Operating revenue CAGR of 4% over 2019-2023 (CAGR of 5.8% in 2014-2018)

- Operating expenditure CAGR of 3.3% over 2019-2023 (CAGR of 6.7% in 2014-2018)

- Capital revenue and capex respectively averaging 7% of total revenue (8.6% in 2014-2018) and 13% of total expenditure (17.6% in 2014-2018)

- Interest rates paid on debt higher than in Fitch's base case by 0.5pp annually over 2019-2023.

RATING SENSITIVITIES

A failure to strengthen the debt payback ratio below 13 years and a debt service coverage ratio above 1x on a sustained basis according to Fitch's rating case will lead to a downgrade.

Kielce, City of; Long Term Issuer Default Rating; Affirmed; BBB; RO:Neg
----; Local Currency Long Term Issuer Default Rating; Affirmed; BBB; RO:Neg
----; National Long Term Rating; Affirmed; A+(pol); RO:Neg

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Additional information is available on www.fitchratings.com

Applicable Criteria

National Scale Ratings Criteria (pub. 18 Jul 2018)

Rating Criteria for International Local and Regional Governments - Effective from 9 April 2019 to 13 September 2019 (pub. 09 Apr 2019)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy