

06 Mar 2020 | Affirmation

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

Fitch Ratings-Warsaw-06 March 2020:

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 Negative.

The Outlook reflects uncertainty over the city's ability to counteract operating expenditure pressure amid mild tax growth, following the state government's decision to raise teachers' salaries from September 2019 and cut personal income tax rates from November 2019. Both those measures will fully impact the city's financial position in 2020 and may threaten the improved operating results brought about by the city's successful cost-rationalisation in 2019, which restored the city's operating results to historical levels.

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

Risk Profile Assessed as Midrange

Kielce's risk profile reflects the combination of five factors assessed as 'Midrange' and one factor assessed as 'Weaker' (revenue adjustability), with the latter carrying lower weight in the overall assessment.

Revenue (Robustness) Assessed as Midrange

Kielce's revenue sources are stable as current transfers account for almost 50% of operating revenue, with the majority transfers from the state budget (A-/Stable) as defined by law. Tax revenue accounts for about 36% of Kielce's operating revenue, of which more than 90% is not dependent on economic cycles. The city also shows a record of operating revenue growth (CAGR of 6.8% in 2015-2019) being above nominal national GDP growth (5.7%), but our assessment is constrained by city's wealth indicators, with a per-capita GDP at 70% of the EU average.

Revenue (Adjustability) Assessed as Weaker

We assess Kielce's ability to generate additional revenue in response to a possible economic downturn as limited, in line with the majority of Polish cities. Income tax rates are set by the central government, as are the majority of current transfers. Kielce has some, but low, flexibility on local taxes as their taxes are constrained by ceilings set in the national tax regulations.

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 has a record of moderate control of operating expenditure growth. This strengthened in 2019 - after weakening in 2017-2018 - following operating cost-rationalisation by the city's authorities, which Fitch expects to continue in the medium term.

We expect the city's capital expenditure to follow a declining trend to about PLN100 million in 2024 from PLN250 million in 2020 as the EU budget period draws to a close, thus turning 5% budget deficits in 2020-2021 to balanced budgets.

Expenditure (Adjustability) Assessed as Midrange

Kielce's ability to reduce spending in response to shrinking revenue is primarily based on capital expenditure (on average 18% of total in 2015-2019), which could be significantly reduced, and operating expenditure, 10% of which is discretionary.

In 2019 the city's authorities took advantage of its spending flexibility, by launching cost rationalisation across the board, including those with the least flexible expenditure, such as administration or social care. The city still has some flexibility on operating expenditure, such as in public transport, culture, sport, and also on capital expenditure (planned PLN800 million over 2020-2024), which consists of small and medium-sized projects, many of which could be scaled down or postponed in case of need.

Liabilities and Liquidity (Robustness) Assessed as Midrange

Kielce's debt is fully denominated in Polish zloty and amortising until 2045, of which 16% is from European Investment Bank (AAA/Stable, undrawn PLN90 million still available for capital expenditure financing). In 2019 the city re-profiled its debt repayment schedule to meet the individual debt service limit for all local and regional governments (LRGs) in Poland. As a result the city's debt repayments are low at PLN20 million annually in 2020-2021 before rising to PLN100 million annually in 2024-2026, in tandem with projected better operating results farther out.

Kielce's debt has floating interest rates, which exposes the city to interest-rate risk as Polish cities are not allowed to use derivatives. However, this is mitigated by a developed national financial market and the city's prudent debt management by setting aside higher amounts than necessary for debt service.

Liabilities and Liquidity Framework (Flexibility) Assessed as Midrange

Fitch assesses the city's liquidity framework as 'Midrange' as a lack of emergency liquidity support from upper tiers of government is offset by liquidity available under a committed liquidity line (with a limit of PLN50 million) provided by ING Bank (A/Stable). Kielce frequently uses this credit line to manage its liquidity during the year and to postpone the drawdown of more costly long-term facilities closer to year-end.

Debt Sustainability Assessment: 'a'

Under its rating case for 2020-2024, Fitch projects the city's debt payback ratio may weaken to 15x in 2020 (11.1x in 2019) following the central government's recent fiscal decisions, before improving to 11x in 2024. The city's fiscal debt burden will remain strong during the forecast period, at about 70% (67% in 2019), which counterbalances the city's weak synthetic debt service coverage of 1x. All this leads to an 'a' debt sustainability assessment.

Derivation Summary

Fitch assesses Kielce's standalone credit profile (SCP) at 'bbb', which reflects a 'Midrange' risk profile and an 'a' debt sustainability. Kielce's SCP assessment factors in peer comparison in the same rating category. The city's final IDRs are not affected by any asymmetric risk or extraordinary support from the Polish state.

Key Assumptions

Qualitative Assumptions and assessments:

Risk Profile: Midrange

Revenue Robustness: Midrange

Revenue Adjustability: Weaker

Expenditure Sustainability: Midrange

Expenditure Adjustability: Midrange

Liabilities and Liquidity Robustness: Midrange

Liabilities and Liquidity Flexibility: Midrange

Debt sustainability: 'a' category

Support: N/A

Asymmetric Risk: 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 2015-2019 figures and 2020-2024 projected ratios. The key assumptions for the rating case include:

- Operating revenue CAGR of 3.8% (7.6% in 2015-2019);
- Operating expenditure CAGR of 3.8% (8.1% in 2015-2019);
- Capital revenue averaging 5% of total revenue and capex averaging 10% of total expenditure; and
- Average debt costs rising to 4.3% in 2024 from 2.5% in 2019.

RATING SENSITIVITIES

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

Liquidity and Debt Structure

In 2019 Kielce improved its operating results with cost rationalisation although the city's council refused to increase the tax rates and fees during 2019, with some hikes in taxes and fees implemented from 2020 (property tax, tickets for public transport or solid waste fee). Operating balance rose to PLN79 million in 2019, from PLN49 million in 2018 and in line with the PLN77 million reported in 2015-2016.

Fitch projects the operating result to weaken in 2020 to about PLN65 million on broadly flat tax revenue and rising operating spending/opex pressure following state government decision to raise

teachers' salaries and cut PIT rates , both fully impacting city's financial position in 2020. This should be followed by a rebound over the next three years as the city's authorities implement all their planned cost- rationalisation measures.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

COMMITTEE MINUTE SUMMARY

Committee date: 3 March 2020

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.

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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Applicable Criteria

[National Scale Ratings Criteria \(pub. 18 Jul 2018\)](#)

[Rating Criteria for International Local and Regional Governments \(pub. 13 Sep 2019\)](#)

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