Research Update:

# Croatia-Based Zagrebacki Holding d.o.o. 'B+' Rating Affirmed; Outlook Stable

**September 9, 2019**

## Rating Action Overview

- Croatia-based multi-utility Zagrebacki Holding d.o.o. (ZGH) continues to demonstrate high leverage, with funds from operations (FFO)-to-debt of 5.5% in 2018 and no expected immediate uptick in performance.
- We see a very high likelihood of the company receiving extraordinary government support in the event of financial distress.
- Therefore, on Sept. 9, 2019, S&P Global Ratings affirmed its 'B+' long-term issuer credit rating on ZGH.
- The stable outlook reflects our expectation that the company's performance will remain stable, with FFO-to-debt at 5%-12%, no significant increase in debt, no further material changes to the group's structure, and no immediate pressures on liquidity given the ongoing support from the city of Zagreb and availability under short-term bank lines.

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## Rating Action Rationale

The rating action reflects our expectations that ZGH's debt will remain high, with little improvement in 2019-2020 compared with 5.5% FFO-to-debt and 11x debt-to-EBITDA in 2018. The affirmation also reflects our view that the company will not face any material liquidity disruptions thanks to ongoing support from its owner, the city of Zagreb, because we expect it to continue rolling over its large short-term bank lines.

Following increasing operating expenses, continued pressure on gas supply and sales revenues, and higher planned staff expense for the waste disposal business over 2019-2020, we do not expect performance to improve in 2019-2020.

After the divestment of its public transport companies in 2018, Zagreb Electric Tram and Zagreb Fairs, ZGH's EBITDA and debt have dropped by about 13% and 10%, respectively. Assuming no further material changes in the group structure, we forecast EBITDA at 450 million-500 Kuna (HRK) million over 2019-2020. We expect debt to be broadly stable, at HRK4.6 billion compared with HRK4.9 billion at year-end 2018, due to broadly neutral discretionary cash flow forecast in 2019-2020.

We believe the likelihood of ZGH receiving timely and extraordinary support from Zagreb remains very high, so we add a two-notch uplift to the 'b-' SACP.

The city of Zagreb is the company's full owner, guarantees its bonds, and significantly influences key strategic decisions. In addition, ZGH has a very important role for the city, because they are monopoly providers of critical city infrastructure services (gas distribution and supply as well as water treatment and waste recycling).

We will continue to monitor whether the gas sector liberalization, as well as the increasing focus on investments in the cleaning and waste segment to comply with EU guidelines on waste management, would affect ZGH's strategy and role for the city's economy, or the government's policy regarding the utility. We continue to see ZGH as a relatively autonomous business, and factor in both positive and negative sides of its relationships with the city, including ongoing subsidies and guarantees, a weak regulatory environment, and the city's tolerance to relatively high debt at the utility level.

## Outlook

The stable outlook on ZGH reflects that on Zagreb and, ultimately, on Croatia. It also reflects our expectation of no significant changes in the group structure, the city's policy to support the company, or ZGH's stable operating performance. We expect FFO-to-debt of 5%-12%, no material increase in debt and no deterioration in liquidity, given ongoing support from the city and continuing rollover of short-term bank lines.

### Downside scenario

A downgrade could follow a material deterioration in liquidity, which is not our base-case scenario as long as support from the city continues.

We could also lower the rating if we downgrade the city to 'BB-' or we perceive a material weakening of government support, for example, due to unexpected changes to the group structure or the city's policy in the gas or waste management sector.

### Upside scenario

An upgrade could follow us upgrading Zagreb to 'BB+', which is not in our base-case scenario given the stable outlook on the city. We view an upgrade because of ZGH's stand-alone credit metrics in the next two years as unlikely. We would consider raising the ratings if we see a track record of improved performance with FFO-to-debt sustainably above 12%, more predictable financial results, at least neutral free operating cash flow, and prudent liquidity management, assuming no change in ongoing and extraordinary support from the city government

## Company Description

ZGH is a diversified conglomerate created in 2006 to streamline control over 22 existing municipal companies and raise external funding for the municipal investment program.

ZGH is 100% owned by the City of Zagreb and is the largest corporate employer in Croatia.

The group includes 15 branches and eight affiliates owned 100% and one affiliate owned 51% by ZGH. These divisions and subsidiaries have quasi-monopolistic positions in providing essential municipal services such as gas supply and distribution, water supply and sewerage, road maintenance, waste disposal, and real estate projects.

Of the group's 24 companies, the gas distribution and supply, and the water treatment divisions, together represent 67% of Zagrebacki's 2018 EBITDA.

## Our Base-Case Scenario

In our base-case scenario, we assume the following:

- Real GDP growth in Croatia of 2.5% in 2019 and in 2020, but no direct link with operating performance;
- Total capital expenditures (capex) of HRK1.1 billion from 2019-2021. The main investments of HRK500 mil annually are at the holding level (including city waste businesses), followed by the water segment with about HRK130 million (of which Croatia Water takes HRK100 million) and the grid business, with about HRK100 million annually for maintenance and replacement purposes. We still do not include a potentially large investment in a new sewage and wastewater treatment plant, which would occur only if ZGH secures EU funding, which is uncertain at this stage;
- A recovery in the waste segment following new pricing tariff (taking effect March 2020)
- No recovery in the gas sector despite the new tariff for gas supply (from a variable tariff to a fixed plus variable tariff) as well as the acquisition and integration of Elektrometal Gas Distribution in 2018. It is mostly due to the low tariffs from the new regulatory period (2018-2021) for gas supply
- Revenues growth and expenses for the water segment at 8% in 2019 following the new tariffs and investment peak (mostly used for network growth and maintenance) at about HRK225 million in 2019, followed by stable growth of about 2% from 2020-2021;
- Corporate income tax of 25% from 2019-2021; and
- No dividends.

Based on these assumptions, we arrive at the following credit measures:

- Debt-to-EBITDA of about 10x in 2019-2020;
- FFO-to-debt of 7%-8% on average in 2019-2020 (excluding dividend income from 100% owned subsidiaries);
- Broadly stable debt of about HRK4.6 billion; and
- Slightly negative free operating cash flows in 2019, turning slightly positive from 2020 onward.

## Liquidity

We assess ZGH's liquidity as less than adequate because its sources won't exceed its uses by more than 1.2x within the next 12 months (as of Dec. 31, 2018).

In our view, the company still has continuing access to bank funding. However, ZGH only refinances short-term committed credit lines from domestic banks ever year; we do not see them as a long-term liquidity source but expect the company to continue this rollover practice.

We understand that the management is pushing to get financial institutions to commit to providing the holding company with long-term credit lines. This would ultimately enhance our assessment of liquidity.

The principal liquidity sources for the 12 months as of Dec. 31, 2018, include the following:

- Balance sheet cash of about HRK250 million as of Dec. 31, 2018
- No available long-term committed bank lines
- HRK 300 million in cash flow from operations

We expect the following principal liquidity uses for the same period:

- Short-term debt maturities of approximately HRK430 million
- Capital expenditures of around HRK 370 million; and
- No dividends payments

## Ratings Score Snapshot

Issuer Credit Rating: B+/Stable/--

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Low risk
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: b-

- Related government rating: BB
- Likelihood of government support: Very high (+2 notches from SACP)

## Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

| Ratings Affirmed | |
|---|---|
| **Zagrebacki Holding d.o.o.** | |
| Issuer Credit Rating | B+/Stable/-- |

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.