

Rating Action: Moody's upgrades ratings of Zagreb and Zagrebacki Holding to Ba1, changes outlooks to stable from positive

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Frankfurt am Main, November 17, 2020 -- Moody's Public Sector Europe ("Moody's") has today upgraded the long-term issuer ratings of the City of Zagreb (Zagreb) and its 100%-owned utility company, Zagrebacki Holding D.O.O. (Zagrebacki Holding), to Ba1 from Ba2 and changed the ratings' outlooks to stable from positive. At the same time, Moody's has upgraded Zagreb's baseline credit assessment (BCA) to ba1 from ba2.

The rating action follows the recent sovereign action on Croatian government. For additional information on the sovereign action, please refer to the press release: https://www.moody.com/research/--PR_434224.

RATINGS RATIONALE

Moody's rating action on the City of Zagreb reflects (1) the improvement in the sovereign creditworthiness, which Croatian sub-sovereigns benefit from; and (2) the city's continued good budgetary management practices and solid financial fundamentals, which will withstand the impact of the coronavirus pandemic-induced shock.

The city's rating upgrade also reflects its solid operating performance with Zagreb's gross operating balance (GOB) averaging 10.1% of operating revenue over the last two years. Moody's expects such healthy operating balances will shield the city's budget from negative effects of the coronavirus pandemic and allow for decent budget flexibility and expenditure cuts. The shared personal income tax (PIT) and surtax on PIT, which together constitute around 70% of the city's operating revenue, will decrease by 7% in 2020 as a result of the economic contraction, before recovering in 2021 if the pandemic is contained. As a result, while Moody's expects Zagreb's GOB will only slightly deteriorate, it will remain between 7%-8% of operating revenue in 2020-21.

Notwithstanding the economic contraction of 8.6% Moody's projects in 2020, stronger national investment prospects under the Next Generation EU program and the new EU Financial Framework 2021-2027 will support the recovery and materially improve the city's medium-term growth prospects, given its key role as the country's economic and financial hub.

Zagreb's rating also reflects Moody's view that the city has continued to pursue a prudent debt policy in a challenging economic environment. Zagreb's direct debt has remained moderate, representing 27% of operating revenue in 2019 and Moody's expects European Union (EU) funds and central government grants to help alleviate Zagreb's financing needs and limit new borrowings for infrastructure investments in 2020-21, resulting in direct debt levels ranging 25%-30% over the same period.

Finally, Moody's takes into account the proactive stance of the central government and passing a new law in September 2020 according to which the government will assume 60% of the total recovery costs from earthquake damage, thus significantly alleviating the pressure from the city finances. Moody's considers positive the central government support measures to offset some tax revenue shortfalls stemming from the COVID-19 pandemic shock by providing compensation funds and interest-free liquidity support to all Croatian local governments.

Today's rating action on Zagrebacki Holding's issuer rating reflects (1) the very strong linkages between the Holding and its support provider, the City of Zagreb, as reflected in Zagrebacki Holding's clear public policy mandate (2) its key role in the city's utilities sector, and (3) Moody's assessment that the City of Zagreb would provide timely support should the entity face acute liquidity stress. As a result, Moody's believes that it is not meaningful to distinguish between the two entities and therefore the Holding's rating is solely derived based on city's creditworthiness.

Zagrebacki Holding's rating benefits from the stable institutional and operational framework and strict control over the Holding's operations exercised by the City of Zagreb. Holding's financial performance strongly depends by the city's decision on its strategies, business plan, investment programme and borrowing plan.

RATIONALE FOR STABLE OUTLOOK

The stable outlook on Zagreb's rating mirrors the stable outlook on the sovereign rating. It also reflects Moody's expectation that the city will be able to preserve its overall stable financial performance, supported by the central government, which will alleviate the pandemic- and earthquake-driven fiscal pressure in 2020-21. The city's history of prudent budgetary management further supports the stable outlook.

The stable outlook on Zagrebacki Holding's rating reflects the stable outlook of its support provider, the City of Zagreb. It also reflects Moody's expectation that the Holding will maintain its strong institutional, economic and financial links with the City of Zagreb.

The sovereign action required the publication of this credit rating action on a date that deviates from the previously scheduled release date in the sovereign release calendar, published on www.moody.com.

The specific economic indicators, as required by EU regulation, are not available for these entities. The following national economic indicators are relevant to the sovereign rating, which was used as an input to this credit rating action.

Sovereign Issuer: Croatia, Government of

GDP per capita (PPP basis, US\$): 29,828 (2019 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 2.9% (2019 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 1.3% (2019 Actual)

Gen. Gov. Financial Balance/GDP: 0.4% (2019 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 2.6% (2019 Actual) (also known as External Balance)

External debt/GDP: [not available]

Economic resiliency: baa1

Default history: No default events (on bonds or loans) have been recorded since 1983.

SUMMARY OF MINUTES FROM RATING COMMITTEE

On 12 November 2020, a rating committee was called to discuss the rating of the Zagreb, City of; Zagrebacki Holding D.O.O.. The main points raised during the discussion were: The systemic risk in which the issuers operate has materially decreased.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

An upgrade of Zagreb's rating would require a similar change in Croatia's sovereign rating associated with a continuation of solid budgetary performance, moderate direct debt levels and gradual indirect debt reduction.

An upgrade of Zagrebacki Holding's rating would result from a similar action on the City of Zagreb's rating, given their close financial and operational linkages.

Although unlikely given the recent sovereign upgrade, a deterioration of the sovereign credit strength would apply downward pressure on Zagreb's rating given the close financial, institutional and operational linkages between the two tiers of governments. Significant financial deterioration driven by reduced operating margins, an unexpected sharp increase in debt as well as the emergence of liquidity risks, would also exert downward pressure on the ratings.

A downgrade of Zagrebacki Holding's rating would result from a downgrade of the City of Zagreb's rating.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE CONSIDERATIONS

Environmental considerations are not material to Zagreb's credit profile. Its main environmental risk exposures relate to earthquakes. However, as evidenced during the earthquake in March 2020, the national government bears most of the costs of reconstruction at the local level. The city has only limited exposure to some flood risk, but in that case, the central government would provide support. Environmental risks are not material to

Zagrebacki Holding's credit profile.

Social considerations are material to Zagreb. Moody's views the coronavirus pandemic as a social risk under its ESG framework, given the substantial implications for public health and safety. Zagreb is more specifically exposed to the evolution of its demography, with its population exposed to net immigration flows.

Social risks are not material to the Zagrebacki Holding's rating.

Governance considerations are material to Zagreb's credit profile. Zagreb uses prudent financing planning, which allows for multiyear forecasting of key trends, providing the city with the ability to identify potential pressures and allowing for sufficient time to adjust plans to mitigate any credit implications.

Governance risks are material to Zagrebacki Holding's rating. The governance framework is intrinsically intertwined with the supporting government, which exerts strong oversight and ultimately takes key decisions.

The methodologies used in these ratings were Regional and Local Governments published in January 2018 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1091595, and Government-Related Issuers Methodology published in February 2020 and available at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1186207. Alternatively, please see the Rating Methodologies page on www.moody.com for a copy of these methodologies.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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Moody's general principles for assessing environmental, social and governance (ESG) risks in our credit analysis can be found at https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_1133569.

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