FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Polish City of Olsztyn at 'BBB'; Outlook Stable

Fri 23 Oct, 2020 - 4:08 PM ET

Fitch Ratings - Warsaw - 23 Oct 2020: Fitch Ratings has affirmed the Polish City of Olsztyn's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB'. The Outlooks are Stable.

The affirmation reflects Fitch's unchanged view that Olsztyn's operating performance and debt ratios will remain in line with 'BBB' rated peers' over the medium term, despite an expected economic downturn triggered by the coronavirus pandemic, and the central government's decisions to cut personal income tax (PIT) and to increase teachers' salaries. Fitch assesses Olsztyn's Standalone Credit Profile (SCP) at 'bbb'.

While Polish local and regional governments' (LRG) most recently available data may not have indicated performance impairment, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and some form of government restrictions are maintained or broadened due to the coronavirus pandemic. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Olsztyn's 'Midrange' risk profile is in line with other Fitch-rated Polish cities'. The risk profile (or debt tolerance) reflects a moderate risk of the city's operating balance shrinking over the medium term to levels that are insufficient to cover debt service or of annual debt service rising above our expectation. The risk profile assessment reflects a combination of one 'Weaker' key factor (revenue adjustability) and five 'Midrange' attributes (revenue robustness, expenditure framework and liabilities and liquidity framework).

Revenue (Robustness) Assessed as 'Midrange'

Olsztyn's 'Midrange' revenue robustness reflects the city's stable revenue with revenue growth prospects being in line with national GDP growth. Tax revenue accounted for almost 38% of Olsztyn's operating revenue in 2019, driven by moderately cyclical economic activities. PIT accounted for 25% of operating revenue, local taxes for 11%; and corporate income tax (CIT), a more volatile revenue item, for less than 2%. Current transfers accounted for more than 46% of operating revenue in 2019, the majority of which were transfers from the Polish State budget (A-/Stable). These transfers are not subject to discretionary changes as the majority of them are defined by law. Olsztyn's tax base is diversified with no concentration risks.

Revenue (Adjustability) Assessed as 'Weaker'

We assess Olsztyn's ability to generate additional revenue in response to possible economic downturns as 'Weaker', in line with the majority of Polish cities', but this is mitigated by a record of revenue growth, even in times of lower GDP growth.

Income tax rates are set by the central government, as are the majority of current transfers. Olsztyn has little flexibility on local taxes (11% of operating revenue) as the city's ability to determine rates on local taxes is constrained by tax ceilings set in national tax regulations. The city can increase its revenue with active asset sales (on average PLN35 million of proceeds in 2014-2019, ie. about 4% of current revenue), but this source of revenue may prove unsustainable in an economic downturn. In our view, additional revenue using discretionary tax leeway would cover less than 50% of a reasonable expected decline of revenue in a downturn.

Expenditure (Sustainability) Assessed as 'Midrange'

Its 'Midrange' expenditure sustainability is in line with the majority of Polish cities'. The city's main responsibilities are moderately non-cyclical, including education, public transport, municipal services, administration, housing, culture, sport, as well as public safety and family benefits that are mandated and financed from the central budget.

The city has a proven record of moderate control of operating expenditure growth. Operating spending has generally grown in line with that of operating revenue, yielding an average operating margin of 5% in 2014-2019 (excluding one-off revenues, such as VAT refunds). Capex is linked to the availability of non-returnable EU grants and is expected by Fitch to remain high in 2020-2024, leading to a budget deficit on average of 3% of total revenue.

Expenditure (Adjustability) Assessed as 'Midrange'

Mandatory responsibilities account for 70%-90% of operating expenditure, including education, social care, administration, public safety and family benefits. The city has higher spending flexibility on other sectors, including public transport, culture, sport, healthcare, and housing.

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Midrange'. The city can reduce at least 10% of its operating expenditure. Capex is, to some extent, flexible as investments tend to be implemented in phases, and can be reduced or postponed in case of need. The city has scope to scale back capex, which represents a high share of total spending. In 2019 the city's capex amounted to PLN173 million or 13% of total expenditure, below the average of 19% of rated cities in Poland.

Liabilities and Liquidity (Robustness) Assessed as 'Midrange'

Fitch assesses the national framework regulations for Polish LRGs' liabilities and liquidity as 'Midrange'.

At end-3Q20 the city's debt portfolio was dominated by bonds at above 92% (with final maturity up to 2035), with the remainder being loans from local banks. However, the maturity profile is smooth with average principal repayments at no more than 11% of outstanding debt. The city's debt is in Polish zloty, but almost all of it has floating interest rates, which exposes the city to interest-rate risk. This is partially mitigated by prudent debt management by setting aside more liquidity than is necessary for debt service.

Liabilities and Liquidity Framework (Flexibility) Assessed as 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' due to moderate counterparty risk, as banks providing liquidity in Poland are rated between 'BBB-' and 'A+'. Additionally, there is no emergency liquidity support from upper tiers of government in Poland.

The city has a history of healthy liquidity, with a liquidity coverage ratio averaging 2.1x in 2010-2019. Cash in the city's accounts during the first three quarters of 2020 was on average above PLN70 million, exceeding scheduled debt servicing in 2020 by more than 1.6x. Additionally, Olsztyn has liquidity available under a committed liquidity line with a limit of PLN50 million.

Debt Sustainability Assessment: 'a'

Under our Rating Criteria for LRGs Fitch classifies Olsztyn - as with all other Polish LRGs - as type B as it covers debt service from its cash flow on an annual basis.

Fitch's rating-case assumptions factor in the economic downturn triggered by the coronavirus pandemic. Our rating case projects a weaker operating balance leading to deterioration of the debt payback ratio (primary metric of debt sustainability for type B LRGs; adjusted net debt-to-operating balance) in 2020-2024 to around 11x (2019: 5.5x).

For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will continue to increase following investments, but still remain strong at around 31% in 2024. The strong fiscal debt burden counterbalances the city's forecast weak synthetic debt service coverage ratio (SDSCR) of around 1.0x in 2024. Olsztyn's debt sustainability metrics remain in line with the current SCP.

Olsztyn's operating balance was on average PLN57 million in 2015-2019 or 6% of operating revenue. In its rating-case scenario, Fitch expects the city's operating balance to decrease in 2020-2024 to around PLN45 million on average due to the economic downturn triggered by the pandemic, and the central government's decisions to cut PIT and to increase teachers' salaries. Under our rating case, we also expect Olsztyn's direct debt to increase, following investments, to above PLN550 million at end-2021 from PLN321 million at end-2019.

Olsztyn is a medium-sized city with just under 172,000 inhabitants and is the capital of Warminsko-Mazurskie Region in northeast Poland. The region is among the bottom-five Polish regions by wealth indicators, and is eligible for additional EU grants for regional development (Operational Programme Eastern Poland 2014-2020). However, Olsztyn is a major administrative, business, cultural and education centre in the region. In Fitch's opinion wealth indicators for the city alone are likely to be above or at least at the national average. The city's economy is diversified, with services playing an important role. This sector contributed about 63.3% of the sub-region's gross valued added in 2017, above the regional average. The unemployment rate in the city (2019: 2.7%) is lower than the national average (5.2%), and much lower than the regional average (9%).

DERIVATION SUMMARY

Olsztyn's 'bbb' SCP reflects a 'Midrange' risk profile and an 'a' debt sustainability. Olsztyn's SCP assessment also factors in peer comparison. The city's IDRs are not affected by other rating factors.

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

Sovereign Cap: no

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 3.9% in 2020-2024

- Operating expenditure CAGR of 4.1% in 2020-2024

- Capital revenue averaging 5% of total revenue and capex averaging 9% of total expenditure up to 2024

- Average debt cost rising to 3.6% in 2024 from 2.3% in 2019

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-Debt payback ratio lower or equal to 10x on a sustained basis under Fitch's rating case.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-Debt payback ratio above 12x on a sustained basis under Fitch's rating case. This could happen if the decline in revenue resulting from the pandemic is larger than currently expected and not matched by a lower amount of expenditure.

- A prolonged COVID-19 impact and much slower economic recovery lasting until 2025 would put pressure on net revenues. Inability to proactively reduce expenditure or supplement weaker receipts from increased central government transfers could lead to a downgrade.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

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Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Olsztyn, City of	LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable
•	LC LT IDR	BBB Rating Outlook Stable	Affirmed	BBB Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 11 Sep 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Olsztyn, City of	EU Issued

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