FitchRatings

RATING ACTION COMMENTARY

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

Fri 23 Apr, 2021 - 5:14 PM ET

Fitch Ratings - Warsaw - 23 Apr 2021: 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 debt metrics, after weakening in 2020-2022 due to a contraction in the operating balance, should recover from 2023 on economic growth. Our rating case projects that the city's credit profile should therefore remain compatible with current ratings and 'BBB'-rated peers'. The city's Standalone Credit Profile (SCP) is 'bbb'.

Feedback

Olsztyn is the capital of the Warminsko-Mazurskie region with about 172,000 inhabitants in mid-2020. The city's unemployment rate was 3.4% at end-2020, below the national average of 6.2%.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Olsztyn's 'Midrange' risk profile reflects our assessment of five factors at 'Midrange' (revenue robustness, expenditure sustainability and adjustability and liabilities and liquidity flexibility and robustness) and one at 'Weaker' (revenue adjustability).

The assessment reflects Fitch's view of a reasonably low risk that Olsztyn's debt service coverage by the operating balance will weaken unexpectedly over the forecast horizon (2021-2025), either because of revenue falling short of expectations or spending exceeding expectations, or an unanticipated rise in liabilities/debt-service requirements.

Revenue Robustness: 'Midrange'

Olsztyn's 'Midrange' revenue robustness reflects the city's stable revenue with revenue growth prospects being in line with national GDP growth. Our rating case expects tax revenue (personal and corporate income taxes (PIT and CIT)) in 2021 to grow at a slower pace than in 2015-2019 due to the economic downturn caused by the pandemic, before rebounding in 2022-2023 on economic recovery.

In 2020 the city's revenue was affected by the central government's decisions to cut PIT rates, as a result of which PIT revenue fell PLN11 million to PLN276 million. The loss in PIT was compensated by increases in revenue from CIT (by 43% or PLN10 million) and in property tax (by 4.3% or PLN4.8 million). The pandemic and lockdown measures also had an impact on the city's revenue, with public transport ticket revenue down 39% at PLN21.6 million in 2020.

Current transfers accounted for almost 46% of total revenue in 2020, the majority of which were from the Polish state budget (A-/Stable). These transfers are not subject to discretionary changes as the majority of them are defined by law. Tax revenue accounted for 33% of Olsztyn's total revenue in 2020, and is based on moderately cyclical economic activities, which means that tax revenues are unlikely to fall materially from a contraction of national GDP. Olsztyn's tax base is diversified with no concentration risks.

Revenue Adjustability: 'Weaker'

We assess Olsztyn's ability to generate additional revenue in response to economic downturns as 'Weaker', in line with the majority of Polish cities'. Income tax rates are set by the central government, as are the majority of current transfers. Olsztyn has little flexibility on local taxes (10% of total revenue) as its ability to determine rates on local taxes is constrained by tax ceilings set in national tax regulations. In our view, additional revenue using discretionary tax leeway is unlikely to cover 50% of an expected revenue decline in an economic downturn.

The city is entitled to receive an equalisation subsidy, but the amounts are negligible relative to its budget (below 1% of total revenue). It can increase its revenue with active asset sales (on average PLN32 million of proceeds in 2015-2020, ie. about 3% of total revenue), but this source of revenue may prove unsustainable in an economic downturn.

Expenditure Sustainability: 'Midrange'

The city's expenditure sustainability is underpinned by non-cyclical responsibilities such as 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.

During the pandemic year the city made savings from closing schools and kindergartens, cancelled cultural and sport events, lower utility charges, reduced purchased services and goods, as well as lower personnel expenditure in the months when the social security fund covered personnel expenses. However, rationalisation of the city's current expenditure was insufficient to maintain its operating balance at 2019 levels. Operating margin decreased to 1.4% in 2020 from 5.9% on average in 2016-2019. However, Fitch expects this to be only temporary, with recovery from 2022.

The city has a 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). We expect capex to be high in 2021-2023 (PLN232 million on average annually), driven by EU co-financed investments. This will lead to budget deficits of 5% of total revenue until 2023 when the budget should gradually move to a balanced result.

Expenditure Adjustability: 'Midrange'

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Midrange'. It has influence on about 10% of current spending, while the remainder is inflexible. The share of inflexible costs is 70%-90% total expenditure and results mainly from mandatory responsibilities in education, family benefits, social care, administration and public safety. Capex is, to some extent, flexible as it is implemented in phases, and can be postponed in case of need. In 2020 the city's capex amounted to PLN97 million or 7% of total expenditure, compared with PLN161 million or 13% on average in 2016-2019.

Liabilities & Liquidity Robustness: 'Midrange'

At end-2020 the city's debt portfolio was dominated by bonds at above 93% (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 12% 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 & Liquidity Flexibility: 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' given the absence of emergency liquidity support from upper government tiers and the lack of banks rated above 'A+' in the Polish market. Historically the city has had strong liquidity with cash and liquid deposits above PLN80 million on average in 2016-2020.

The city has a committed credit line of PLN50 million, which was barely used in the last five years. This, together with PLN120 million of unrestricted cash, exceeded annual debt service of PLN36 million at end-2020. In 2021 Olsztyn plans to issue PLN86 million bonds for capex financing. It also has available a PLN21 million credit facility from Bank Gospodarstwa Krajowego (BGK; A-/Stable) for pre-financing EU co-financed projects.

Under our rating case, we expect Olsztyn's net adjusted debt to increase, following investments (mainly EU co-financed), to above PLN400 million at end-2023 from PLN182 million at end-2020.

Debt Sustainability: 'a category'

Fitch classifies the City of Olsztyn as a type B local and a regional government (LRG), as it covers debt service from its cash flow on an annual basis.

Feedback

Under its rating case for 2021-2025, factoring in the economic downturn triggered by the coronavirus pandemic, Fitch projects debt payback to weaken to above 11x in 2022 (2020: 10.7x), before it improves to below 11x in 2024-2025 (corresponding to the mid-point of an 'a' debt sustainability score). Its fiscal debt burden ratio will peak following investments in 2023, but will still remain strong at below 30% in the medium term ('aaa' debt sustainability score). The strong fiscal debt burden ratio counterbalances the city's weaker synthetic coverage ratio of 1.1x on average in 2021-2025 ('bb' debt sustainability score), which together with the debt payback, results in a final debt sustainability assessment of 'a'.

Olsztyn's operating balance decreased to PLN17 million in 2020, from PLN42 million in 2019. Operating margin fell to around 1.4% due to almost flat tax revenue growth in 2020 and operating spending pressure in education following state government decisions. Additionally, the city received PLN7 million less revenue from solid waste fee due to a regulatory change in the waste-disposal fee calculation.

We expect the city's operating balance to remain weak in 2021 due to delayed effects of the economic downturn triggered by the pandemic. This is followed by a rebound from 2022 on a projected recovery in tax proceeds and on most exceptional expenses not being repeated. This should lead to an improvement of the city's main financial metrics in 2023-2025.

DERIVATION SUMMARY

Fitch assesses Olsztyn's SCP at 'bbb', which results from a 'Midrange' risk profile and an 'a' assessment of debt sustainability. Olsztyn's SCP assessment is mainly due to its primary metric of debt payback and also factors in peer comparison in the same rating category. No other rating factors affect the ratings.

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'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap: 'N/A'

Sovereign Floor: '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 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- 3.9% yoy increase in operating revenue on average

- 3.7% yoy increase in operating spending on average

- Negative net capital balance of PLN68 million on average

- Average debt costs rising to 2.9% in 2025 from 2% in 2020

Feedback

RATING SENSITIVITIES

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO NEGATIVE RATING ACTION/DOWNGRADE:

-Debt payback rising above 11.5x on a sustained basis under Fitch's rating case.

FACTORS THAT COULD, INDIVIDUALLY OR COLLECTIVELY, LEAD TO POSITIVE RATING ACTION/UPGRADE:

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

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 RATING

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

ESG CONSIDERATIONS

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

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

FITCH RATINGS ANALYSTS

Michal Ochijewicz
Analyst
Primary Rating Analyst
+48 22 338 6285
Fitch Ratings Ireland Limited spolka z ograniczona odpowiedzialnoscia oddzial w Polsce
Krolewska 16, 00-103 Warsaw

Maurycy Michalski
Director
Secondary Rating Analyst
+48 22 330 6701

Guilhem Costes
Senior Director
Committee Chairperson
+34 91 076 1986

MEDIA CONTACTS

Athos Larkou
London
+44 20 3530 1549
athos.larkou@thefitchgroup.com

Malgorzata Socharska
Warsaw
+48 22 338 6281
malgorzata.socharska@fitchratings.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 27 Oct 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Olsztyn, City of	EU Issued, UK Endorsed

DISCLAIMER

READ LESS

Feedback

COPYRIGHT

security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

Feedback

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

International Public Finance Supranationals, Subnationals, and Agencies Europe Poland

---

ga('set', '732-ckh-767', 'USER_ID');

Feedback