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CREDIT OPINION
25 September 2018

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RATINGS

Olsztyn, City of

Domicile	Poland
Long Term Rating	Baa1
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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City of Olsztyn (Poland)

Update to credit analysis

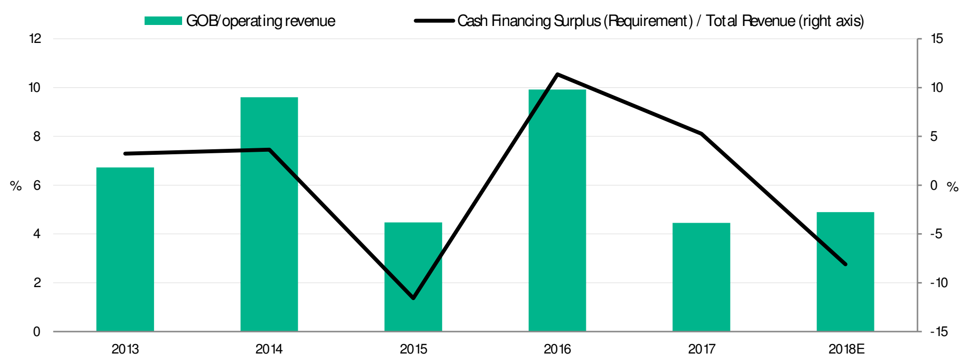
Summary

The credit profile of the City of Olsztyn (Baa1 stable) reflects its track record of satisfactory operating surpluses supported by prudent budgetary management and growing tax revenue, good financial performance, adequate cash reserves as well as a moderate likelihood that the Government of Poland (A2 stable) would provide support if the city were to face acute liquidity stress. Other factors underpinning the rating include the decreasing debt levels and manageable debt service costs, due to a favorable amortizing debt structure.

At the same time the City of Olsztyn's rating is constrained by the city's investment requirements, which could exert a pressure on the budget. The limited tax revenue control under the current legislative framework also mitigates the credit positives.

Exhibit 1

Continued satisfactory budgetary performance



Source: City of Olsztyn, Moody's Public Sector Europe, E - estimate

Credit strengths

» Satisfactory operating performance supported by growing tax revenue

» Moderate debt levels but set to increase in 2018-19

» Comfortable cash reserves

Credit challenges

» Capital spending may strain the city's budget

» Limited revenue and expenditure flexibility

Rating outlook

The stable outlook reflects our expectations that Olsztyn will maintain its adequate financial position and moderate debt levels.

Factors that could lead to an upgrade

» An upgrade of the City of Olsztyn's rating would require an upgrade of the sovereign rating, associated with significant improvement of the city's operating margin and sustained balanced financial performance.

» Significant change in the Polish RLGs' revenue and expenditure flexibility and ability to raise an additional own-source revenues would also have positive implications on the rating.

Factors that could lead to a downgrade

» A downgrade of Poland's sovereign rating would lead to a similar action on Olsztyn's rating.

» A significant deterioration in financial performance and cash reserves and/or an increase in debt levels above 60% of operating revenue may exert downward rating pressure.

Key indicators

Exhibit 2
City of Olsztyn

	2013	2014	2015	2016	2017
Current Intergovernmental Transfers/Operating Revenue (%)	40.83	39.18	38.74	41.63	44.84
Cash Financing Surplus (Requirement)/Total Revenue (%)	3.24	3.63 -	11.58	11.36	5.28
Interest Expense/Operating Revenue (%)	1.55	1.07	0.79	0.88	0.73
Gross Operating Balance/Operating Revenue (%)	6.73	9.60	4.47	9.92	4.45
Self-financing Ratio	1.19	1.19	0.74	3.28	1.43
Net Direct and Indirect Debt/Operating Revenue (%)	34.28	28.50	41.83	30.05	29.59
Debt Service/Total Revenue (%)	6.36	7.05	4.00	7.35	4.65
CAPEX/Total Expenditure (%)	17.74	19.53	39.50	5.62	12.91

Source: City of Olsztyn, Moody's Public Sector Europe

Detailed Credit Considerations

The credit profile of the City of Olsztyn, as expressed in Baa1 rating, combines (1) a baseline credit assessment (BCA) of baa2; and (2) a moderate likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

SATISFACTORY OPERATING PERFORMANCE SUPPORTED BY GROWING TAX REVENUE

Olsztyn continues to generate satisfactory operating surpluses that have stabilised below 10% of operating revenue. The operating surplus amounted to PLN44 million in 2017 representing 4.5% of operating revenue down from 10% recorded in 2016. Operating revenues continue to grow at a satisfactory pace, mainly driven by the tax revenue and intergovernmental transfers growth. Higher proceeds from personal income tax, representing 24.5% of the city's operating revenue, increased by 6.2% year-on-year, while the property tax collection improved by 6.3%, reflecting a positive development in the national and local economies (4.7% real GDP growth in 2017).

Central government transfers, which are earmarked for education and social benefits, grew by 9.5% in 2017, accounting for 45% of Olsztyn's operating revenue up from 42% in 2016, thus further reducing budgetary flexibility of the city.

We expect operating margins to improve slightly in 2018-19, driven by the good economic prospects of the national economy and forecasted GDP growth of 5% in 2018 and 4.2% in 2019, which will translate into rising receipts from shared taxes and central government transfers. In addition, the city's proven ability to control operating expenditure growth will also help the city to achieve its fiscal targets.

In 2017, operating expenditures amounted PLN936 million, higher than in 2016 (PLN867 million). Personnel costs consumed a high 36% of operating expenditures, followed by education, transportation, social and healthcare costs, all together representing more than 50% of operating expenditures.

MODERATE DEBT LEVELS BUT SET TO INCREASE IN 2018-19

In 2017, the city's direct debt stood at PLN243 million representing a moderate 25% of the city's operating revenue, down from 30% in 2016 (42% in 2015). Despite planned new bond issuance, we expect the city's debt burden to stay below 40% of its operating revenue until 2019, secured by revenue growth and amortisation of the city's obligations.

Olsztyn's debt portfolio is split between bonds (59% of total debt), bank loans (38%) and 3% comprised of state supported environmental loans. While the city's debt has no foreign-currency exposure, the majority of it is floating, which exposes the city to interest-rate volatility. Owing to long maturities, the city's debt service is highly manageable and will not exceed 2% of total revenues in 2018. The current weighted average maturity is around 8 years, easing refinancing needs.

We consider the debt of the city's transport company MPK (PLN46.5 million in 2017) to be an indirect liability. The company depends financially on the city, and its investments and debt stem from its decision to expand the public transport network. As such, we expect further increases in the company's debt. When adding the indirect debt of MPK, the net direct and indirect debt of Olsztyn represented 30% of operating revenue at year-end 2017.

COMFORTABLE CASH RESERVES

A good financial performance enabled the city to improve its cash position over the last two years. At year-end 2017, cash reserves accounted for a comfortable 10% of its operating revenue slightly up from 9.8% in 2016. As projected, the city's liquidity position deteriorated in H1 2018 with cash reserves of PLN76 million following the increased capital spending, of which partly being funded by the city's available cash.

Olsztyn's liquidity position is sufficient to cover 5.5x of its debt servicing costs falling due in 2018 and we do not expect this ratio to deteriorate in medium term.

The city has adopted a prudent cash management strategy. A comfortable level of cash, regular proceeds from taxes, and a schedule of transfers help the city to better manage its finances. Olsztyn has an access to PLN50 million short-term credit line, which could help the city to meet any pre-financing needs or cover a potential temporary shortfall between revenues and expenditures.

CAPITAL SPENDING MAY STRAIN THE CITY'S BUDGET

In 2017, the city generated a cash financing surplus (PLN60 million or 5.3% of total revenue) for a second consecutive year, after a large deficit of 11.6% posted in 2015. However, these surpluses in 2016-17 are primarily associated with a slower implementation of EU-sponsored infrastructure projects, as evidenced by a fall in capital spending to an average of PLN96 million in 2016-17 (9.3% of total expenditure) from an average of PLN251 million (23.4% of total expenditure) during 2012-15. Recent developments point to an accelerated execution in capital spending, which have a potential to put a pressure on the city's budget resulting in a small financial deficits in 2018-19.

According to the citty's capital investment plan for 2018, Olsztyn will spend PLN445 million on infrastructure projects. Major projects are related to the transport sector, particularly the development of a new tramway network and purchasing of new trams, energy efficiency measures, modernization of football stadium and road reconstruction. The city's investments also include projects focused on education, environmental and social services. Current projections indicate that more than half of total capital expenditure will be co-financed from the EU and the remainder will be funded from own sources.

The city's another investment priority, which will be implemented by the city owned heating company, is the construction of a new waste-fueled Combined Heat & Power (CHP) plant, whose funding structure includes the participation of external equity financing, state funds and EU grants under the Infrastructure and Environment Operational Programme within the framework 2014-2020.

Over the same period, the city will likely use its municipal companies to ensure the execution of some of its capital investments. We will monitor these developments to determine if such off-balance sheet operations could be considered debt-like obligations for the city.

LIMITED REVENUE AND EXPENDITURE FLEXIBILITY

Olsztyn has limited control over its revenue and operating expenditure bases under the current institutional framework. Local taxes, which allow for some discretion over rates, are of limited importance (15% of operating revenues in 2017), while state transfers and shared taxes (personal income tax and corporate income tax) still represent the greater part of Olsztyn's revenues (70% in 2017).

We do not expect that the composition of Olsztyn's operating revenue will significantly differ in 2018, given that local finances in Poland depend on the decisions of the central government, which leaves the local governments with only marginal leeway with regard to taxes and fees.

In terms of operating expenditure, Olsztyn has to manage a large and evolving scope of competencies including social expenditure, healthcare, housing and public transport, over which the city has limited flexibility given the strategic and sensitive nature of these responsibilities.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government reflects our assessment of the central government's promotion of greater accountability for Polish RLGs and its relatively strong oversight of local government finances. The system of oversight implemented by the central government also requires regular monitoring of cities' indebtedness.

Rating Methodology and Scorecard Factors

The assigned BCA of baa2 is in line with the scorecard-indicated BCA of baa3. The matrix-generated BCA of baa3 reflects (1) an Idiosyncratic Risk score of 5 (presented below) on a 1-9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of A2, as reflected in the sovereign bond rating.

For details about our rating approach, please refer to the Regional and Local Governments rating methodology (published January 2018).

Exhibit 3

Rating Factors						
Olsztyn, City of						
Baseline Credit Assessment	**Score**	**Value**	**Sub-factor Weighting**	**Sub-factor Total**	**Factor Weighting**	**Total**
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	83.71	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	6	20%	1.20
Financial flexibility	7		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	5.97	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	1	0.78	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	1	29.59	25%			
Short-term direct debt / total direct debt (%)	3	18.71	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**4.57(5)**
Systemic Risk Assessment						**A2**
Suggested BCA						**baa3**

Source: City of Olsztyn, Moody's Public Sector Europe

Ratings

Exhibit 4

Category	Moody's Rating
OLSZTYN, CITY OF	
Outlook	Stable
Issuer Rating	Baa1

Source: Moody's Investors Service

REPORT NUMBER 1142950

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