

Fitch Rates Polish City of Olsztyn 'BBB'; Outlook Stable

Fitch Ratings - Warsaw - 22 November 2019:

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

The ratings reflect Fitch's view that Olsztyn's operating performance and debt ratios will remain in line with 'BBB'-rated peers over the medium term. Fitch assesses Olsztyn's standalone credit profile (SCP) at 'bbb'.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Olsztyn's 'Midrange' risk profile reflects five 'Midrange' key factors and a 'Weaker' key factor, with a lower weighting of the latter in the overall assessment.

Revenue Robustness: 'Midrange'

We assess Olsztyn's revenue robustness as 'Midrange' due to stable revenue sources with revenue growth prospects being in line with national GDP growth. Tax revenue accounted for almost 40% of Olsztyn's operating revenue in 2018, based on moderately cyclical economic activities. Personal income tax accounted for 26% of operating revenue, local taxes for 13% while the more volatile corporate income tax (CIT) at only below 2%. Current transfers accounted for almost 44% of operating revenue in 2018, with the majority being transfers from the 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: 'Weaker'

We assess Olsztyn's ability to generate additional revenue in response to possible economic downturns as 'Weaker', in line with most Polish cities, but this is partially mitigated by the city's proven track record of revenue growth, even in times of slower 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 (13% of operating revenue) as the city's ability to determine rates on local taxes is constrained by legal ceilings set in national tax regulations. The city can potentially increase its revenue with intensive asset sales (on average PLN36 million of proceeds in 2014-2018, ie. about 3% of total revenue), but this source of revenue may prove not sustainable in an economic downturn.

Expenditure Sustainability: 'Midrange'

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

Olsztyn has a track record of moderate control of operating expenditure growth. Olsztyn's operating spending growth has generally been in line with that of operating revenue, yielding an average operating margin of 5% in 2014-2018 (excluding one-off revenues, such as VAT refunds). We expect the city's capex to remain high in 2019-2023 (average 14% of total spending), leading to budget deficits on average of up to 5% of total revenue under our rating case.

Expenditure Adjustability: 'Midrange'

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Midrange'. It has influence over at least 10% of current spending, while the remainder is inflexible. Olsztyn's inflexible costs result from mandatory responsibilities in education, family benefits, social care, administration and public safety, which together accounted for about 75% of operating expenditure in 2018. The city has higher spending flexibility in respect to other sectors, including public transport, culture, sport, healthcare, and housing. Capex is, to some extent, flexible as investments tend to be implemented in phases, and can be reduced or postponed in case of need. In 2018 capex was at a high 22% of total spending, significantly above the average of other rated Polish cities.

Liabilities and Liquidity Robustness: 'Midrange'

Fitch assesses the national framework regulations for Polish local and regional governments' (LRGs) liabilities and liquidity as 'Midrange'.

At end-1H19 the city's loan portfolio was dominated by bonds at 92% (with final maturity up to 2032) and the remainder being loans from local banks. However, the maturity profile is smooth with average principal repayments not exceeding 12% of outstanding debt. The city's debt is in Polish zloty with floating interest rates, which exposes the city to interest-rate risk. The city partially mitigates this risk by prudently setting aside more funding than necessary for debt service.

Liabilities and Liquidity Flexibility: 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' given the lack of emergency liquidity support from upper tiers of government, but Olsztyn has liquidity available under its committed liquidity line (with a limit of PLN50 million).

The city has a history of sound liquidity, with a liquidity coverage ratio averaging 2.1x in 2010-2018. Cash and liquid deposits in 2018-2019 are on average above PLN70 million.

Debt sustainability: 'a' category

Under our new criteria introduced in April 2019 (Rating Criteria for International Local and Regional Governments) Fitch classifies the City of Olsztyn - as with other Polish LRGs - as type B as it covers debt service from its cash flow on an annual basis.

Under its rating case for 2019-2023, Fitch projects the city's debt payback ratio (adjusted net debt-to-operating balance), which is the primary metric of debt sustainability assessment for Type B LRGs, will grow, to just below 11x, up from about 5x in 2018, in line with an 'a' assessment. For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will increase following investments during the forecast period, to around 35% in 2023 from about 22% in 2018, which, however, is still in line with an 'aaa' assessment. This 'aaa' fiscal debt burden, together with our 'bb' assessment of the city's synthetic debt service coverage ratio (SDSCR; about 1x in 2018), results in a debt sustainability assessment of 'a'.

Olsztyn is a medium-sized city with over 172,000 inhabitants and is the capital of Warmińsko-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 business, cultural and educational centre in the region. In Fitch's opinion the city's wealth indicators 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 62.2% of the sub-region's gross valued added in 2016, above the regional average. The unemployment rate in the city (2018: 3.4%) is lower than the national average (5.8%).

RATING DERIVATION

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 also factors in peer comparison. There is no other rating factor affecting the city's IDRs.

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

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 2014-2018 figures and 2019-2023 projected ratios. The key assumptions for the rate case include:

- Operating revenue CAGR of 3.1% over the next five years;
- Operating expenditure CAGR of 3.4% over the next five years;
- Capital revenue and capex based on the city administration's long-term projections and in line with past trend of investments
- Interest rates paid on debt higher than in base case by 0.25pp annually from 2021

Quantitative assumptions – sovereign related

- Figures as per Fitch's sovereign actual for 2018 and forecast for 2021, respectively:
- GDP per capita (US dollar, market exchange rate): 15,541 and 16,834
- Real GDP growth: 5.2% and 2.9%
- Consumer prices (annual average change): 1.2% and 2.5%
- General government balance (of GDP) : -0.4% and -1.9%
- General government debt (of GDP) : 48.5% and 47.1%
- Current account balance plus net foreign direct investments (of GDP) : 1.4% and 0.6%
- Net external debt (of GDP): 23.4% and 22.9%
- IMF development classification: emerging market
- CDS market-implied rating: N/A

RATING SENSITIVITIES

The ratings could be upgraded if Olsztyn maintains its debt payback ratio below 10x on a sustained basis under Fitch's rating case.

The ratings could be downgraded if Olsztyn's debt payback ratio deteriorates above 12x on a sustained basis under Fitch's rating case.

ESG CONSIDERATIONS

RATING ACTION COMMENTARY

ESG credit relevant is a score of 3, meaning that ESG issues are credit-neutral. Given the mission of the issuer and the institutional framework, these issues are minimally relevant to the rating.

COMMITTEE MINUTE SUMMARY

Committee date: 20 November 2019

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

[Rating Criteria for International Local and Regional Governments \(pub. 13 Sep 2019\)](#)

ADDITIONAL DISCLOSURES

[Dodd-Frank Rating Information Disclosure Form](#)

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RATING ACTION COMMENTARY

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