

Credit Opinion: Cape Town, City of

Global Credit Research - 17 Feb 2015

South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	A1.za
NSR Senior Unsecured -Dom Curr	A1.za
NSR ST Issuer Rating -Dom Curr	P-1.za

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Key Indicators

Cape Town, City of

	2010	2011	2012	2013	2014
Net direct and indirect debt/Operating revenue (%)	34.2	26.9	22.5	27.0	20.7
Interest Payments/Operating Revenue (%)	3.9	3.7	3.2	3.0	3.1
Gross Operating Balance/Operating Revenue (%)	6.7	9.3	7.7	6.7	4.9
Cash Financing Surplus (Requirement)/Total Revenue (%)	-5.3	5.0	4.2	-3.2	-8.0
Intergovernmental Transfer/Operating Revenue (%)	7.1	7.2	7.6	8.3	9.2
Real GDP (% change) [1]	3.1	3.6	3.2	2.3	-
GDP per capita as % of National Average	134.3	125.9	124.3	122.1	-

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

The City of Cape Town's A1.za/P-1.za national scale issuer and debt ratings reflect the city's good budgetary performance, strong liquidity position and moderate debt levels. The financial position is supported by the administration's prudent financial policies and the relatively large size and diversification of its economic base.

On 10 November 2014, Moody's downgraded the City of Cape Town's rating by one notch, following the weakening of South Africa's credit profile as captured by the downgrade of the sovereign rating to Baa2 from Baa1 with a stable outlook on 6 November.

National Peer Comparison

The City of Cape Town is rated at the high end of the range of South African municipalities rated by Moody's, whose ratings span from A1.za to Baa3.za. Cape Town's relative position reflects debt levels that are in line with the median of other metropolitan cities. Cape Town compares favourably with the other metros in South Africa in

terms of budgetary performance and management, and displays robust cash holdings.

Credit Strengths

- Strong financial position, including robust liquidity
- Prudent financial management
- Moderate debt relative to budget volumes
- Large and diversified economic base

Credit Challenges

- Sizeable capital expenditure programme, which will increase financial leverage

Rating Outlook

The outlook on Cape Town's ratings is stable.

What Could Change the Rating - Up

An upgrade of Cape Town's ratings will likely require an upgrade of the sovereign rating.

What Could Change the Rating - Down

A downgrade of the sovereign rating could likely lead to a downgrade of Cape Town's ratings. Furthermore, Cape Town's ratings would come under pressure in the event of deterioration in fiscal discipline, resulting in the weakening of its liquidity position and/or a substantial increase in its financial leverage.

Recent Developments

The weakening of South Africa's credit profile, as captured in the one-notch downgrade of the sovereign rating to Baa2 from Baa1 on 6 November 2014, prompted a similar downgrade of nine regional and local governments' ratings, including that of the City of Cape Town. The deterioration in South Africa's sovereign creditworthiness indicates a weakening operating environment for sub-sovereign issuers. The centralised nature of South Africa's local public sector results in close operational and financial links between the national government, large cities and medium-sized municipalities, whose budgetary structure and relative size expose them to the country's macroeconomic performance and socio-economic conditions to varying degrees. Small municipalities are highly reliant on government transfers for operating and capital investments.

DETAILED RATING CONSIDERATIONS

Cape Town's A1.za rating combines (1) the entity's baseline credit assessment (BCA) of baa2, and (2) a moderate likelihood of extraordinary national government support if the City faced acute liquidity stress.

Baseline Credit Assessment

STRONG FINANCIAL POSITION, INCLUDING ROBUST LIQUIDITY

Cape Town's FY2014 revenue of ZAR28.1 billion (US\$2.5 billion) places it second among South African cities. Property taxes and service charges dominate its revenue structure and constituted 75% of 2014 operating revenue, helping the city record a strong 15% Compound Annual Growth Rate (CAGR) over the past five years. As of FYE2014, its operating fiscal transfers rose to ZAR2.4 billion, from ZAR1.9 billion in FY2013 and contributed significantly to the city's revenue growth.

Like other metropolitan municipalities, Cape Town has broad operating- and capital-related expenditure responsibilities, most of which are essential yet expensive services, which reduces its overall expenditure flexibility. On the operational expenditure side, fixed items such as bulk purchases and employee costs contribute 62% of operating expenditures in 2014 FY thus offer limited expenditure flexibility.

The strong liquidity position enabled Cape Town to finance its cash financing deficit of 8% (or ZAR2.2 billion) in 2014 entirely from its own cash investments at the expense of borrowings, which resulted in debt to operating revenue declined to 21% from 27% in 2013. The results of financing a large part of capital expenditure from its own

funds led to a decline in its liquidity ratio to 1.0x from 1.4x in 2013 which still compares favourably relative to other rated metropolitan municipalities in the country. The strong liquidity level is underpinned by the city's consistently high revenue collection rates of above 95% recorded in both financial years 2013 and 2014.

The City recorded a relatively moderate gross operating balance to operating revenue of 4.9% in FY2014, although it dropped slightly from 6.7% in FY2013 - reflecting the city's ability to contain accruing operating expenses well within corresponding revenues.

PRUDENT FINANCIAL MANAGEMENT

Cape Town's financial governance is focused on maintaining financial soundness. The administration regularly monitors its budget execution and cash flows and is committed to reinforcing internal controls. As in previous financial years, the city received an unqualified audit report for the financial year ending 30 June 2014. The city also maintained a clean audit with respect to last year's financial performance. Notwithstanding its plans to significantly increase capital expenditures, which will increase its financial leverage in the medium term, the city follows prudent financial, debt and liquidity management policies.

MODERATE DEBT RELATIVE TO BUDGET VOLUMES

As of 30 June 2014, the city's net direct debt was 21% of operating revenue, down from 27% during the year prior, as robust cash flow enabled the city to finance 48% of its capital investments from own funds.

Cape Town's debt stock comprises domestic bonds (61%) and bank loans (39%), all denominated in domestic currency and at fixed rates. The average maturity of the city's debt is around 10.6 years and the bulk of the debt, in bonds, is secured with sinking funds, estimated at ZAR1.6 billion for FY2014 (this amount is netted off Moody's debt ratios in FY2014). Cape Town's interest payments, which absorbed a moderate 3.1% of operating revenues in FY2014, are projected to grow gradually in the medium term, in tandem with the increasing debt.

LARGE AND DIVERSIFIED ECONOMIC BASE

Cape Town is the second-largest city in South Africa. It is the capital city of the Western Cape Province, which is the second-wealthiest province in South Africa after Gauteng, as reflected by higher-than-average levels of income per capita. With around 3.7 million inhabitants, Cape Town makes up roughly 64% of the total provincial population and is the main driver of the Western Cape's economic activity. The local economy is evenly diversified, with manufacturing and various business activities in the tertiary sector, such as finance, insurance and retail contributing significantly to the GDP of the region. Cape Town in Western Cape drives the provincial economy and consequently its contribution to national economic output is significant. In addition to financial services, port activities and tourism contribute meaningfully to the local output. Situated in one of the world's busiest trade routes, the Port of Cape Town is one of the largest deepwater harbours in Africa and also contributes to the local economy. Tourism is regarded as a major growth sector as far as investment, employment and the diversification of services are concerned.

SIZEABLE CAPITAL EXPENDITURE PROGRAMME WILL INCREASE FINANCIAL LEVERAGE

The City of Cape Town has substantially increased its investment in fixed assets over the past few years. The city plans to spend about ZAR5.7 billion per annum on capital investments in the medium term as capital transfers are set to marginally decline, of which ZAR7.3 billion of the total capital investment plan will be financed through borrowings. This will result in debt to operating revenue increasing to 31% by June 2017 from 21 % in 2014. Whilst Cape Town's debt exposure does not present a significant credit risk, Moody's will continue to monitor the extent to which the expansive medium term capital programme affects the city's ability to generate adequate cash flow surpluses.

Extraordinary Support Considerations

Moody's assigns a moderate likelihood of extraordinary support from the national government, reflecting, at the jurisdictional level, Moody's assessment of the national government's policy stance of promoting greater accountability and financial sustainability for South African municipalities. Reputation risk for the central government is deemed modest, mainly in view of the predominance of bank loans instead of bonds. Although the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bail-out actions to avoid defaults on debt obligations. However, Moody's recognises some interest of the government in addressing major financial problems that could be experienced by the metropolitan municipalities, in view of their relative importance countrywide.

Output of the Baseline Credit Assessment Scorecard

In the case of Cape Town, the BCA matrix generates an estimated BCA of baa3, close to the BCA of baa2 assigned by the rating committee.

The matrix-generated BCA of baa3 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Baa2, as reflected in the sovereign bond rating (Baa2 stable).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

(BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Cape Town, City of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	122.04	70%	1	20%	0.20
Economic volatility	1		30%			

Factor 2: Institutional Framework						
Legislative background	5		50%	5	20%	1.00
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	5.94	12.5%	1.75	30%	0.53
Interest payments / operating revenues (%)	5	3.07	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	20.70	25%			
Short-term direct debt / total direct debt (%)	1	5.20	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.03(2)
Systemic Risk Assessment						Baa2
Suggested BCA						baa3

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