MOODY'S
INVESTORS SERVICE

CREDIT OPINION
19 March 2019

Update

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RATINGS

Cape Town, City of

Domicile	Cape Town, South Africa
Long Term Rating	Baa3
Type	LT Issuer Rating - Dom 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 Cape Town (South Africa)

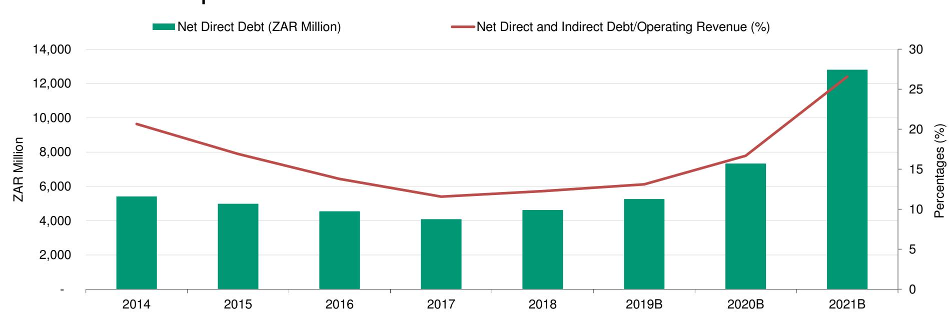
Update following change in outlook to stable from negative

Summary

The credit profile of the City of Cape Town (Baa3/Prime-3), reflects the city's strong financial performance, which is supported by (1) prudent financial management, (2) its large and diversified economic base, and (3) its predictable sources of revenue from property taxes and service charges. The city has consistently generated operating surplus, strong liquidity compared with that of its peers we rate in South Africa (Baa3 stable) and low debt, although we expect debt to rise significantly over the next three years as a result of the city's focus on improving the resilience of its water infrastructure following last year's water crisis. The city's credit profile is constrained by Cape Town's capital spending pressure, as a result of (1) water shortage because of drought, (2) infrastructure backlogs, and (3) population growth.

Exhibit 1

Cape Town's debt is set to increase over the next three years, but will remain lower than its rated South African peers



Source: City of Cape Town's financials, Moody's Investors Service calculations

Credit strengths

» Favorable financial management, characterized by annual operating surplus

» Strong financial management and debt management

» Large and diversified economic base

Credit challenges

» Rising debt level, but debt burden will remain lower than that of the other metros we rate in the country

» Increasing capital spending pressure on water infrastructure to mitigate impacts of water shortages

Rating outlook

The stable rating outlook reflects our expectation that Cape Town will maintain its strong operating performance and stable cash flow. The city's strong liquidity further supports the stable outlook.

Factors that could lead to an upgrade

An upgrade of the city's Baa3 global scale rating would largely depend on an upgrade of the rating of its support provider, the Government of South Africa.

Factors that could lead to a downgrade

Although a downgrade is currently unlikely in view of the stable outlook, we would consider downgrading Cape Town's rating if its liquidity and operating performance deteriorated and sustained that deterioration and debt burden increases beyond our current expectations. Cape Town's global scale rating could also be downgraded in the event of a downgrade of the South African government bond rating.

Key indicators

Exhibit 2

City of Cape Town

Fiscal year ended 30 June 2018

Key Indicators						
Cape Town, City of						
	2013	**2014**	**2015**	**2016**	**2017**	**2018**
Net direct and indirect debt/Operating revenue (%)	27.0	20.7	16.9	13.8	11.6	12.3
Interest Payments/Operating Revenue (%)	3.0	3.1	2.6	2.3	2.1	2.1
Gross Operating Balance/Operating Revenue (%)	6.7	5.1	13.2	13.0	15.0	16.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	-3.2	-7.1	4.7	0.5	0.9	3.3
Intergovernmental Transfer/Operating Revenue (%)	8.3	16.3	17.8	17.1	16.5	17.1
Real GDP (% change) [1]	2.5	2.0	1.5	1.1	-	-
GDP per capita as % of National Average	125.7	126.4	120.8	121.7	-	-
[1] GDP at provincial level.						

Source: Moody's Investors Service

Detailed credit considerations

On 15 March 2019, Moody's changed the outlook on City of Cape Town's rating to stable from negative, and affirmed the issuer and senior unsecured debt ratings of Baa3 (global scale) and Aaa.za (national scale). The outlook change reflects our view that the City of Cape Town, managed successfully to avert "Day Zero" in the short term -- the day in which the city would have had to turn off its municipal water supply -- and that its new water strategy will more effectively adapt the city's water sector to the continued environmental risk posed by climate change. We also expect the city to maintain its strong liquidity despite its plan to increase borrowing over the next three years. Moody's revises the outlook of the City of Cape Town's rating to stable and affirms its ratings

The credit profile of the City of Cape Town, as expressed in its Baa3/Aaa.za rating, combines (1) a Baseline Credit Assessment (BCA) of baa3, and (2) a moderate likelihood of extraordinary national government support if the city faces acute liquidity stress.

Baseline Credit Assessment

Favorable financial management, characterized by annual operating surplus

The City of Cape Town generally exhibits favorable financial performance, averaging a gross operating balance of 13% of operating revenue over 2014-18. As of 30 June 2018, the city recorded total revenue of ZAR39.5 billion ($3.2 billion), the second highest among South African cities, after Johannesburg. We expect the city's financial performance over the next three years to remain strong but a little lower than that in the past, with an average gross operating balance as a percentage of operating revenue of 9.8% over the period from the fiscal year ended 30 June 2019 (fiscal 2019) to fiscal 2021. The city displays strong revenue-generating capabilities, with its own sources contributing 82% of its operating revenue in fiscal 2018 and likely to contribute 83% on average over the next three fiscal years starting July 2018. Property taxes and service charges will remain the main contributers to the city's operating revenue, averaging 73% of the operating revenue in the next three years (2019-21), helping the city achieve an average operating revenue growth rate of 9% over the same period.

The city has broad operating and capital spending responsibilities, most of which are related to essential and expensive services. This reduces the city's overall spending flexibility, especially related to the water crisis. On the operational expenditure side, fixed items such as bulk purchases and employee costs accounted for 61% of the city's operating expenditure in fiscal 2018, limiting expenditure flexibility. We expect no changes in the operating expenditure structure over the next three years, with fixed items contributing 61% to the operating revenue in each year.

Strong financial management and debt management

The administration regularly monitors its budget execution and cash flow and is committed to reinforcing internal controls. As in the previous fiscal years, the city received an unqualified audit report for fiscal 2018. Despite challenges associated with water crisis, the city managed to control operating performance and post a strong operating balance of 16.3% in fiscal 2018 from 15% in fiscal 2017. The city follows prudent financial, debt and liquidity management policies.

Large and diversified economic base

Cape Town is the second-largest city in South Africa in terms of budget size after Johannesburg. It is the capital city of the Western Cape Province and the second-wealthiest province in South Africa after Gauteng, as reflected in the higher-than-average levels of income per capita. With around 4 million inhabitants, Cape Town makes up roughly 64% of the total provincial population and is the main driver of the Western Cape Province's economic activity. The local economy is relatively diversified, with manufacturing and various business activities in the tertiary sector (such as finance, insurance, tourism and retail) contributing significantly to regional GDP. Cape Town drives the provincial economy because it contributes 70% of 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 on one of the world's busiest trade routes, the port of Cape Town is one of the largest deepwater harbors in Africa. Commercial services is the largest economic sector as far as investments, employment and the diversification of services are concerned.

Rising debt level, but debt burden will remain lower than that of the other metros we rate in the country

The city issued new debt of ZAR1 billion in fiscal 2018. As a result, its net direct debt increased to 12% of the operating revenue from 11% the previous year. Its robust cash flow enabled the city to post a cash financing surplus of 3.3% in fiscal 2018, up from 0.9% in fiscal 2017. Cape Town's debt stock comprises domestic bonds (77%) and bank loans (23%), all denominated in domestic currency and at fixed rates. The bulk of the city's debt is financed through bonds, which are secured via sinking fund investments, estimated at ZAR2.3 billion in fiscal 2018 (this amount is netted off our debt ratios in fiscal 2018). Cape Town's debt is set to increase substantially to fund its increasing capital spending. The city plans to borrow ZAR500 million in fiscal 2019, ZAR2.5 billion in fiscal 2020 and ZAR5.9 billion in fiscal 2021. This will increase the city's net direct debt to ZAR12.8 billion by fiscal 2021, with the net direct and indirect debt as a percentage of operating revenue rising to 26%. The increase in borrowing will also result in an increase in interest payments as a percentage of operating revenue to 4% in fiscal 2021 from 2% in fiscal 2018. However, the city's projected indebtedness will still be in line with that of other metropolitan municipalities we rate in the country. If it fully implements its capital spending plans, the city's net direct and indirect debt will increase to 26% of operating revenue by fiscal 2021, from a low 12% in fiscal 2018. Borrowing will dominate capital infrastructure spending over the next three years, accounting for 37% of the total, while transfers will contribute 29% and own funds 34%.

However, the city's consistently strong liquidity will help ease the pressure from the rising debt. Cape Town has consistently maintained strong cash flows which support its robust liquidity profile, with a liquidity ratio of 1.8x as of the end of fiscal 2018. The city's liquidity profile is expected to remain strong despite the city's intention to fund about one third of its capital expenditure plan in the next three years from own sources.

Increasing capital spending pressure on water infrastructure to mitigate impacts of water shortages

Challenges associated with the water crisis have prompted the city to increase borrowing for the first time in five years. In fiscal 2018, the city launched its first green bond in a ZAR1 billion issuance to finance water, sanitation and transport projects. The city plans to spend about ZAR25 billion on capital infrastructure from fiscal 2019 to fiscal 2021.

Though the city managed to alleviate the water crisis through various methods of demand reduction and water augmentation projects, it still plans to invest more in water infrastructure to try and avoid another crisis in the future. The city has outlined and budgeted for a number of projects aimed at diversifying water sources to be implemented over the next 10 years. To this end, 50% of the planned capital spending for 2019-21 focuses on water and sanitation infrastructure in the city. A total of ZAR2.8 billion from the allocation for water infrastructure will focus specifically on the infrastructure identified in its new water strategy.

Extraordinary support considerations

We consider the City of Cape Town to have a moderate likelihood of extraordinary support from the national government, reflecting, at the jurisdictional level, the assessment of the national government's policy stance of promoting greater accountability and financial sustainability for South African municipalities. Reputational 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, we recognize 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.

Rating methodology and scorecard factors

The assigned BCA of baa3 is close to the BCA of ba1 generated by the scorecard. The matrix-generated BCA of ba1 reflects (1) an Idiosyncratic Risk score of 2 (presented below) on a scale of 1 to 9, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Baa3, as reflected in the sovereign bond rating of South Africa.

For details about our rating methodologies, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018.

Exhibit 3

City of Cape Town

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	121.70	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 (%)	1	15.46	12.5%	1.25	30%	0.38
Interest payments / operating revenues (%)	3	2.13	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	12.30	25%			
Short-term direct debt / total direct debt (%)	1	5.50	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						**1.88(2)**
Systemic Risk Assessment						**Baa3**
Suggested BCA						**ba1**

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
CAPE TOWN, CITY OF	
Outlook	Stable
Issuer Rating -Dom Curr	Baa3
NSR Issuer Rating	Aaa.za
Senior Unsecured -Dom Curr	Baa3
NSR Senior Unsecured	Aaa.za
ST Issuer Rating -Dom Curr	P-3
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

REPORT NUMBER 1145968

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