MOODY'S
INVESTORS SERVICE

CREDIT OPINION
1 December 2020

Update

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RATINGS

Cape Town, City of

Domicile	Cape Town, South Africa
Long Term Rating	Ba2
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

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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Cape Town, City of

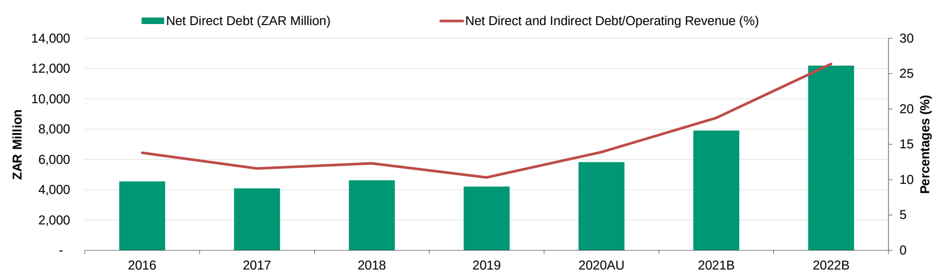
Update following rating downgrade to Ba2

Summary

The City of Cape Town's (Ba2/NP negative) credit profile reflects its strong financial performance, which is supported by prudent financial management; a large and diversified economic base; and predictable revenue sources from property taxes and service charges. The city has consistently reported an operating surplus, stronger liquidity than its peers in South Africa (Ba2 negative) and low debt, although we expect debt to rise gradually over the next three years. The city's credit profile is constrained by the capital spending pressure arising from infrastructure backlogs and population growth. It is also constrained by the impact of the coronavirus pandemic, which has hurt operating performance and weakened liquidity, although it remains stronger than that of its peers in the country that we rate. The low economic growth will constrain the city's financial performance in the form of lower revenue collection resulting from higher unemployment.

Exhibit 1

Debt will increase over the next three years, but remain lower than that of its peers



Fiscal year ending 30 June.
Sources: City of Cape Town's financials and Moody's Investors Service

Credit strengths

» Favourable financial performance, characterised by annual operating surpluses

» Strong financial and debt management practices

» Large and diversified economic base

Credit challenges

» Rising debt level, although it will remain lower than that of South Africa's other metros

» Increasing capital spending pressure to improve water infrastructure to mitigate the impact of drought

Rating outlook

The negative rating outlook reflects the weakening credit profile of the city's support provider, the South African government, taking into account their strong operational and financial links.

Factors that could lead to an upgrade

Given the negative outlook, an upgrade is currently unlikely. The city's rating outlook could be changed to stable if the outlook on the South African government's rating were to change from negative to stable.

Factors that could lead to a downgrade

The city's rating could be downgraded if the Ba2 sovereign rating is downgraded. Additionally, it could be downgraded if its liquidity and financial performance were to deteriorate.

Key indicators

Exhibit 2

City of Cape Town

	2016	2017	2018	2019	2020 [1]
Net direct and indirect debt/Operating revenue (%)	13.8	11.6	12.3	10.3	11.4
Interest Payments/Operating Revenue (%)	2.3	2.1	2.1	1.8	1.9
Gross Operating Balance/Operating Revenue (%)	13.0	15.0	15.5	17.5	12.5
Cash Financing Surplus (Requirement)/Total Revenue (%)	0.5	0.9	3.3	7.1	0.5
Intergovernmental Transfer/Operating Revenue (%)	17.1	16.5	17.1	17.2	17.8
Real GDP (% change) [2]	1.1	1.2	0.8	-	-
GDP per capita as % of National Average	121.7	118.1	118.1	-	-
[1] 2020 based on October section 71 report					
[2] GDP at provincial level.					

Fiscal year ending 30 June.
Source: Moody's Investors Service

Detailed credit considerations

On 25 November 2020, we downgraded the City of Cape Town's global scale ratings to Ba2/NP from Ba1/NP and maintained the negative outlook. The downgrade of the city's ratings reflects the challenges emanating from the weakening of the sovereign credit profile. We view the centralised nature of the regional and local government (RLG) sector in South Africa and the close financial links between the national government and the RLGs as the factor that keeps the city's ratings at par with the sovereign bond rating. At the same time, we affirmed the long-term and short-term national scale issuer and debt ratings of Aaa.za/P-1.za.

The credit profile of the City of Cape Town, as expressed in its Ba1 rating, combines a Baseline Credit Assessment (BCA) of ba1 and a low likelihood of extraordinary support from the national government in the event that the city faces acute liquidity stress.

Baseline Credit Assessment

Favourable financial performance, characterised by annual operating surpluses

The City of Cape Town's operating performance was significantly hurt by the pandemic, according to the October 2020 section 71 report. However, the city has been recording very strong operating performance over the years, it still recorded a positive gross operating balance of 12.5% in fiscal 2020, compared with 17.5% in fiscal 2019. We expect the city to continue to post a strong operating balance compared with other metros in the country that we rate despite challenges related to the pandemic. For fiscal 2020, the city recorded total revenue of ZAR43.8 billion ($3.2 billion), the second highest among the South African cities after Johannesburg (Ba2 negative). However, we expect the city's financial performance over the next three years to decline because of the pandemic, with an average gross operating balance of 5.7% over fiscal 2020-22. The city has strong revenue-generating capacity, with its own-source revenue contributing 82%

of its operating revenue in fiscal 2020. Own-source revenue will likely contribute the same proportion, on average, over the three years starting fiscal 2020. Property taxes and service charges will remain the primary contributers to the city's operating revenue, averaging 73% of operating revenue in the next three fiscal years (fiscal 2020-22).

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. Fixed items such as bulk purchases and employee costs accounted for 63% of the city's operating expenditure in fiscal 2020, limiting expenditure flexibility. We do not expect changes to the operating expenditure structure over the next three years.

Strong financial and debt management practices

The administration regularly monitors its budget execution and cash flow, and is committed to reinforcing internal controls. As in previous fiscal years, the city received an unqualified audit report for fiscal 2019. However, challenges related to the pandemic will significantly reduce the city's overall performance in the next three years, although it 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 four million inhabitants, Cape Town makes up roughly 64% of the total provincial population and is the main hub of the Western Cape Province's economic activity. The local economy is relatively diversified, with manufacturing and various business activities in the tertiary sector (including finance, insurance, tourism and retail) contributing significantly to regional GDP. Cape Town drives the provincial economy, contributing around 70%. As a result, its contribution to national economic output is significant. In addition to financial services, port activities and tourism contribute meaningfully to local output. Situated on one of the world's busiest trade routes, the port of Cape Town is one of the largest deep water harbours in Africa. Commercial services is the largest economic sector in terms of investments, employment and the diversification of services.

Debt level rising, but will remain lower than that of South Africa's other metropolitan municipalities

According to the October 2020 section 71 report, the city issued new debt of ZAR1.1 billion. As a result, its net direct debt increased to 11.4% of operating revenue from 10.3% in fiscal 2019. Cape Town's debt stock comprises domestic bonds (77%) and bank loans (23%), all denominated in the 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 ZAR2.5 billion in fiscal 2020 (this amount is netted off our debt ratios in fiscal 2020). Cape Town's debt is set to increase to fund its increasing capital spending. The city plans to borrow ZAR2.5 billion in fiscal 2021 and a further ZAR5 billion in fiscal 2022. If the city fully implements its capital spending plans, its net direct debt will increase to ZAR14.7 billion by fiscal 2022, with 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 2.7% in fiscal 2022 from 1.8% in fiscal 2019. However, the city's projected debt will still be in line with that of South Africa's other rated metropolitan municipalities.

The city's consistently strong liquidity will help ease the pressure from rising debt. Cape Town has consistently maintained strong cash flow, which supports its robust liquidity profile (a liquidity ratio of 2.2x as of year-end fiscal 2019). Cape Town's liquidity is likely to remain strong despite the city's intention to fund a large part of its capital spending in the next three years from own funds.

Increasing capital spending pressure to improve water infrastructure to mitigate the impact of water shortage

Challenges associated with the water crisis have prompted the city to increase borrowing to fund capital spending. 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 around ZAR29 billion on capital infrastructure over fiscal 2020-22.

Although the city managed to alleviate the water crisis — through various methods of demand reduction and water augmentation projects — it still plans to invest further in its water infrastructure to try to avoid another crisis. The city has outlined and budgeted for a number of projects aimed at diversifying water sources to be implemented over the next 10 years. Of the total capital spending budget for fiscal 2020-22, 34% in fiscal 2020, 42% in fiscal 2021 and 43% in fiscal 2022 is earmarked for water-related infrastructure. Although the city's debt is likely to increase over the next three years as a result of the increase in capital spending, it will remain lower than that of its South African peers that we rate.

Extraordinary support considerations

The City of Cape Town has a low likelihood of extraordinary support from the national government, reflecting, at the jurisdictional level, the national government's policy stance of promoting greater accountability for South African municipalities. This assessment is in line with the national government's stance to encourage municipalities to be self-sustainable. Although the legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bailout actions to avoid defaults on debt obligations.

ESG considerations

How environmental, social and governance risks inform our credit analysis of the City of Cape Town

We take account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of the City of Cape Town, the materiality of ESG factors to its credit profile is as follows:

Environmental considerations are material to Cape Town's credit profile. Similar to the rest of South Africa, the city's main exposures relate to water shortage. Drought is the most frequent environmental constraint that directly affects the city's revenue. This challenge is managed through partnerships between the central government's department of water and the city. However, some of the financial burden for implementing and maintaining diverse water sources will be borne by the city. A three-year drought recently caused Cape Town's dam system levels to deteriorate significantly, and the city has, in response, launched a new strategy to build an integrated water management system that will result in more diverse water sources.

Social considerations are material to the city's credit profile. Although the economy is large and relatively richer than the national average, the city faces growing demography-related spending pressure. Demographic pressure is likely to continue to rise as a result of high levels of urbanisation and population growth, and it will become increasingly difficult for the city to meet the required capital infrastructure spending. The city also has a high unemployment rate, which directly affects the ability of the city's residents to pay for services, and increases the number of households that are entirely dependent on the city for basic services. In addition, South Africa has one of the highest inequality rates in the world, and this also filters through to local governments, giving rise to risks of social unrest. We also view the pandemic as a social risk under our ESG framework, given the impact on public health and safety in the City of Cape Town.

Governance considerations are material to Cape Town's credit profile. The city's strong administration has implemented prudent financial practices over the years, which has led to the city attaining an unqualified audit opinion over the past 15 years. Similar to those of all local governments in South Africa, Cape Town's financial undertakings are guided by the Municipal Finance Management Act and the national government, although the treasury plays an oversight role. Data transparency is very high, with all financial statements, along with medium-term budgets, published publicly on the city and national treasury's websites.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

Rating methodology and scorecard factors

The assigned BCA of ba2 is similar to the BCA of ba2 generated by the scorecard. The matrix-generated BCA of ba1 reflects 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 a Systemic Risk score of Ba2, as reflected in the sovereign bond rating of South Africa.

For details about our rating methodologies, please refer to our Regional and Local Governments rating methodology, published on 16 January 2018.

Exhibit 3

City of Cape Town

Regional and Local Governments

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	3	118.10	70%	2.4	20%	0.48
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 (%)	1	14.36	12.5%	1.25	30%	0.38
Interest payments / operating revenues (%)	3	1.90	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	11.40	25%			
Short-term direct debt / total direct debt (%)	1	6.10	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						**2.36(2)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba2**

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
CAPE TOWN, CITY OF	
Outlook	Negative
Issuer Rating -Dom Curr	Ba2
NSR Issuer Rating	Aaa.za
Senior Unsecured -Dom Curr	Ba2
NSR Senior Unsecured	Aaa.za
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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