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CREDIT OPINION
10 June 2021

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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City of Cape Town (South Africa)

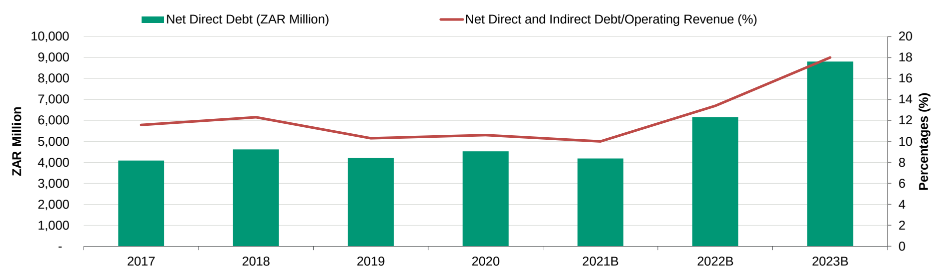
Update to credit analysis

Summary

The credit profile of the City of Cape Town (Ba2/NP negative) reflects its strong financial performance, 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 robust operating surplus, stronger liquidity than its peers in South Africa (Ba2 negative) that we rate and low debt. Although we expect debt to rise gradually over the next three years, it will remain lower than that of its peers in the country, see exhibit 1 below. 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 weakened the city's operating performance. However, the city's overall financial performance remains stronger than that of rated peers in South Africa.

Exhibit 1

Debt will increase in the next three years, but remain lower than that of rated peers in the country



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, although it will remain lower than that of other metros in South Africa

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

Rating outlook

The negative rating outlook mirrors that of its support provider, the South African government, taking into account their strong operational and financial linkages between the two.

Factors that could lead to an upgrade

Given the negative rating 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 to stable from negative.

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	2021 B	2022 B
Net direct and indirect debt/Operating revenue (%)	13.8	11.6	12.3	10.3	10.6	10.0	13.4
Interest Payments/Operating Revenue (%)	2.3	2.1	2.1	1.8	1.8	2.0	1.7
Gross Operating Balance/Operating Revenue (%)	13.0	15.0	15.5	17.5	12.4	3.2	4.7
Cash Financing Surplus (Requirement)/Total Revenue (%)	0.5	0.9	3.3	7.1	0.4	-7.1	-5.4
Intergovernmental Transfer/Operating Revenue (%)	17.1	16.5	17.1	17.2	17.6	20.2	17.2
Real GDP (% change) [1]	1.1	1.2	0.8	-	-	-	-
GDP per capita as % of National Average	121.7	118.1	118.1	-	-	-	-
[1] GDP at provincial level.							

Fiscal year ending 30 June.
2021-22: Issuer budget
Source: Moody's Investors Service

Detailed credit considerations

The credit profile of the City of Cape Town, as expressed in its Ba2 rating, combines a Baseline Credit Assessment (BCA) of ba2 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 also hurt by the pandemic. The city's gross operating balance declined to 12.4% in 2020 from 14.5% in 2019. However, its overall performance remains stronger than that of peers in the country that we rate. We expect the city to continue to post a strong operating balance compared with other metros in the country that we rate despite pandemic-related challenges. In the fiscal year that ended 30 June 2020 (fiscal 2020), the city recorded total revenue of ZAR44.8 billion ($2.9 billion), the second highest among the South African cities after Johannesburg (Ba2 negative). However, we expect the city's financial performance to decline over the next two fiscal years because of the pandemic, with an average gross operating balance of 4.7% over fiscal 2021-22. The low growth in operating results are driven by high increase in salary costs which is expected to grow by 14% on average in fiscal 2021 and 2022, compared to 4% growth recorded between fiscal 2019 and 2020. Service charges are also expected to grow by 4% on average in fiscal 2021 and 2022 when compared to a 6% growth recorded between fiscal 2019 and 2020.

The city has high revenue-generating capacity, with its own-source revenue contributing 88% of its operating revenue in fiscal 2020. Own-source revenue will likely contribute the same proportion, on average, over the next three fiscal years. Property taxes and service charges will remain the primary drivers of the city's operating revenue, averaging 73% of operating revenue in the next three fiscal years (fiscal 2021-23).

The city has broad operating and capital spending responsibilities, most of which are related to essential and expensive services. On the expenditure side, fixed-cost items — such as bulk purchases and salary costs — contributed 61% of operating expenditure in fiscal 2020, which limits the city's expenditure flexibility. We do not expect changes in the operating expenditure structure over the next three fiscal 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 2020. However, pandemic-related challenges will significantly weaken the city's overall performance in the next three fiscal years, although the city continues to follow prudent financial 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 which is the second-wealthiest province in South Africa after Gauteng, as reflected in the higher-than-average levels of income per capita. With more than four million inhabitants, Cape Town accounted for 68% of the total provincial population in 2018. Cape Town is also 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 the national economic output is significant. The Western Cape province also had the lowest official unemployment rate of 22.5% in 2020, compared with that of other provinces. In addition to financial services, port activities and tourism contribute significantly to the 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.

Rising debt, although it will remain lower than that of other metros in South Africa

In the fiscal year that ended 30 June 2020, the city issued new borrowing of ZAR1.1 billion. As a result, its net direct debt increased to 10.6% of operating revenue from 10.3% in fiscal 2019. Cape Town's debt stock comprises domestic bonds (70%) and bank loans (30%), 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 ZAR2.8 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 2022 and a further ZAR4.5 billion in fiscal 2023. As result, the city's net direct debt will increase to ZAR8.9 billion by fiscal 2023, with net direct and indirect debt as a percentage of operating revenue rising to 18%. However, it is highly unlikely that the city will increase its borrowing to the projected levels because of its very strong liquidity position as well its historical conservative approach towards borrowing.

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 [current assets/current liability] of 2.0x as of year-end fiscal 2020). 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 with own funds.

Increasing capital spending pressure to improve the provision of basic infrastructure

The city plans to spend around ZAR24 billion on capital infrastructure over fiscal 2021-23. Although the city managed to alleviate the water crisis in 2018— 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. Although the city's capital budget declined from ZAR6.7 billion in the 2020 budget to a released ZAR6 billion, its investment in water related infrastructure increased to ZAR2.1 billion in 2020 from ZAR1.6 billion in 2019. The water supply improvement was supported by the city's implementation of a number of strategies such as pressure management, rolling out water management devices and leak detection and repairs. These strategies kept the water demand level to a low 600 million liters per day from 1 billion liters in 2015. The improvement was also related to a better rain fall in 2019 and 2020. As a result, major water storage capacity improved from 46% in 2019 to 55% in 2020. As at 31 May 2021 the average water storage further improved to 75%.

The city has outlined and budgeted for a number of projects aimed at diversifying water sources to be implemented over the next 10 years. In order to achieve these projects, the city's capital spending on water related infrastructure is projected to further increase to ZAR3.3 billion per annum from fiscal 2021-2023 period. Although the city's borrowing will increase as a result, its overall level of indebtedness 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 those of 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 16 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's 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 Environmental, Social and Governance Risks, published in April 2021.

Rating methodology and scorecard factors

The City of Cape Town's assigned ba2 BCA is in line with the ba2 BCA generated by the scorecard. The scorecard-indicated BCA of ba2 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 by the sovereign bond rating for South Africa.

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

Exhibit 3
Cape Town, City of
Regional and Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals				**2.40**	**20%**	**0.48**
Economic Strength [1]	3	118.09%	70%			
Economic Volatility	1		30%			
Factor 2: Institutional Framework				**6**	**20%**	**1.20**
Legislative Background	5		50%			
Financial Flexibility	7		50%			
Factor 3: Financial Position				**1.25**	**30%**	**0.38**
Operating Margin [2]	1	17.56%	12.5%			
Interest Burden [3]	3	1.83%	12.5%			
Liquidity	1		25%			
Debt Burden [4]	1	11.36%	25%			
Debt Structure [5]	1	6.12%	25%			
Factor 4: Governance and Management				**1**	**30%**	**0.30**
Risk Controls and Financial Management	1					
Investment and Debt Management	1					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**2.36 (2)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba2**

[1] Local GDP per capita as a percentage of national GDP per capita.
[2] Gross operating balance/operating revenue.
[3] Interest payments/operating revenue.
[4] Net direct and indirect debt/operating revenue.
[5] Short-term direct debt/total direct debt.
Source: Moody's Investors Service, fiscal 2020

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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