MOODY'S INVESTORS SERVICE

CREDIT OPINION
27 June 2023

Update

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RATINGS

Cape Town, City of

Domicile	Cape Town, South Africa
Long Term Rating	Ba3
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)

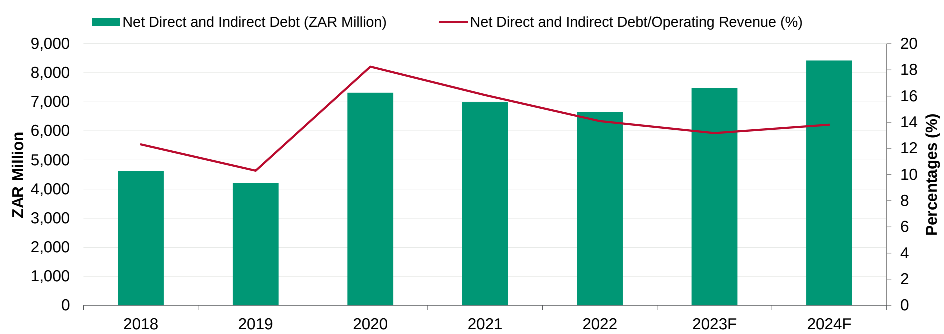
Update following rating affirmation

Summary

The credit profile of the City of Cape Town (Ba3/NP stable) reflects its consistently strong and improving operating and financial performance, which demonstrates resilience in its liquidity positions. The city has low debt levels albeit debt is expected to gradually increase in the medium term. We note a track record of improved management policies and practices, which should help the city to maintain sound financial metrics, despite constraints by growing infrastructure spending pressure to address social and environmental risks as well as the country's structurally weak economic environment. The city itself enjoys a broad and diversified economic base. The city also faces physical climate and water management risks, as well as social risks such as access to adequate housing and labor market challenges.

Exhibit 1

Debt level is expected to rise in the medium term, but remains comparatively low



Fiscal year ending 30 June.
F: Forecast
Source: Moody's Investors Service, City of Cape Town's Financial statements

Credit strengths

» Robust financial performance, albeit challenged by low economic growth environment

» Strong debt management practices and sturdy liquidity

» Large and diversified economic base

Credit challenges

» Rising debt, albeit likely to remain relatively low

» Growing pressure to increase capital spending

Rating outlook

The outlook is stable, reflecting its robust financial performance and demonstrated resilience in its liquidity positions and expected stable operating performances over the next two years. Moreover, sound liquidity positions should help them to navigate the uncertain economic environment. We expect the city's continuation of strong financial performance with some but limited new debt in the medium term due to infrastructure spending needs.

Factors that could lead to an upgrade

A rating upgrade is unlikely, considering the stable outlook assigned to the city. We would consider an upgrade if the city displayed consistently stronger operating performance and liquidity, in the context of the operating environment's structural challenges.

Factors that could lead to a downgrade

We would consider a downgrade of the ratings if the city experiences significant deterioration in operating performance and liquidity or if debt increases significantly. We would also consider a rating downgrade if the sovereign were downgraded.

Key indicators

Exhibit 2

City of Cape Town

City of Cape Town	2018	2019	2020	2021	2022	2023 F	2024 F
Net direct and indirect debt/Operating revenue (%)	12.3	10.3	18.2	16.1	14.1	13.2	13.8
Interest Payments/Operating Revenue (%)	2.1	1.8	2.0	1.9	1.6	1.5	1.6
Gross Operating Balance/Operating Revenue (%)	15.5	17.7	6.8	6.9	9.2	13.2	13.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	3.3	7.1	0.6	-2.3	1.2	2.4	2.9
Intergovernmental Transfer/Operating Revenue (%)	17.1	17.4	12.4	18.7	17.3	16.0	16.6
Capital Expenses/Total Expenses (%)	14.3	13.0	12.9	13.3	10.6	9.6	9.2

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

Detailed credit considerations

On 23rd June 2023, we affirmed the Ba3 long term ratings of City of Cape Town and maintained stable outlook.

The credit profile combines a baseline credit assessment (BCA) of ba3 and a low likelihood of extraordinary support from the national government in the event that the city faces acute liquidity stress.

Baseline credit assessment

Robust financial performance, albeit challenged by the low economic growth environment

The city's gross operating balance (GOB) most recently improved to 9.2% of operating revenue in fiscal year 2022, up from 6.9% in previous fiscal year. The improvement indicates robust collection rate as well as contained operating expenditures. The city's tariff strategy is driving mostly its operating performance. Energy tariffs charged to residents are increased at a lower rate than that imposed by Eskom (Caa1 positive), the country's dominant electricity producer. This ensures affordability for most residents, so that the city can continue to have a diversified revenue collection base (ranging from low-income to high-income residents). The strategy resulted in a high revenue collection rate of 98% in fiscal 2021.

Property taxes and service charges were the primary drivers of the city's operating revenue, amounting to more than 70% of operating revenue in fiscal 2022- limiting the city's revenue flexibility. Though the city has low revenue flexibility, the city's high revenue collection capacity has ensured that the city maintains overall robust operating performance during the past 5 fiscal years. With the implemented tariff strategy, we expect the revenue collection rate to remain high in the medium term.

Fixed cost items – such as bulk purchases and salary costs – accounted for more than 50% of operating expenditures according to fiscal 2022, which limits the city's operating expenditure flexibility. However, the city has managed to contain operating expenditure such that they have maintained positive GOB's during the past 5 fiscal years (2018-2022). Rising fuel prices- and thus increased inflation- are expected to push up bulk purchase costs- weighing on operating expenditures in the medium term.

We expect the city to maintain solid gross operating surpluses in the medium term- resulting from high collection rates, with expectation to reach double digit percentage of GOB/operating revenues in coming two years.

Strong financial and debt management practices and sturdy liquidity

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 2022. However, operating environment structural challenges will add some pressure to the city's overall performance in the next three fiscal years. We note that a track record of strong and improved financial management policies and practices, should help the city to maintain sound financial metrics despite upcoming infrastructure spending over the medium term.

The city has continued to demonstrate sturdy liquidity, with its cash position covering its most immediate obligations at an estimated cash ratio (Cash And Cash Equivalents) / (Current Liabilities + Current/ Short-Term Debt) of 1x according to fiscal 2022. We expect the forecasted average cash ratio to remain at 1x between fiscal 2023-24.

Large and diversified economic base

Cape Town is the second largest city in South Africa in terms of budget size. 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. 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 national economic output is significant. Cape Town performs relatively well when compared to the Western Cape and national unemployment rates, with the fiscal 2021 unemployment rate being 27.5% (which is still high and indicative of an economy where access to economic opportunities remains constrained). In addition to financial services, port activities and tourism contribute significantly 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.

Rising debt, albeit likely to remain relatively low

Net direct and indirect debt (NDID) remained low at 14% of operating revenues according to fiscal 2022. The city's medium term capital spending plans indicate additional long-term borrowing, but not planned to exceed modest debt level over the coming decade. Over the coming 3 years, a level of NDID of 20% of operating would be expected to be reached.

The city's short-term debt has risen significantly during the past few years (about 20% of total direct debt in fiscal 2022, compared to only 6% the previous year. This was because of bond repayments due in the following year. We expect short term debt to remain a considerable share of the debt portfolio.

Cape Town's debt stock as of fiscal year-end 2022 comprises domestic bonds (73%) and bank loans (27%) – all denominated in the domestic currency and at fixed rates. The bonds are secured via sinking fund investments, at ZAR3.4 billion in fiscal 2022. However, following the bond repayments, the city intends to borrow from DFI's or other commercial institutions – depending on the best rates they receive and is unlikely to go to the bond market again, as bank loans are cheaper than what the bond market is offering.

Growing pressure to increase capital spending

The city uses a combination of debt (19%), grants (30%) and own-source revenue (51%) to finance its capital spending programme. The city's long term capital investment projects comprises planned spending amounting to ZAR120 billion, partly debt funded. It comprises mostly water and waste water projects but also energy related projects to support ending load-shedding- through the use of alternative energy sources, independent power producers (IPPs) and buying surplus energy from all energy producers (commercial, industrial & resident); and focusing on the city's safety and security – (CCTV products and drones).

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 avoid another crisis. A significant increase (forecast 42% average increase between fiscal 2022-2025) in water CAPEX, due to the planned implementation of an important project to improve the resilience of the city's water network, is expected in the medium term. The city's exposure to water management risks are a key driver of our environmental risk assessment. Moreover, rising electricity shortages as well as historically poorly maintained infrastructure – which, among inequality and labour market constraints, are key drivers of social risks – also place all South African municipalities under growing capital spending pressure.

Despite the increased medium term capital spending needs, we expect the cash financing surplus to remain positive, averaging a forecasted 2% to 3% of total revenue during fiscal 2023-25.

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

City of Cape Town's ESG Credit Impact Score is Highly Negative CIS-4

Exhibit 3
ESG Credit Impact Score

CIS-4
Highly Negative

NEGATIVE IMPACT | POSITIVE IMPACT

For an issuer scored CIS-4 (Highly Negative), its ESG attributes are overall considered as having a discernible negative impact on the current rating. The negative influence of the overall ESG attributes on the rating is more pronounced compared to an issuer scored CIS-3.

Source: Moody's Investors Service

City of Cape Town's ESG Credit Impact Score (**CIS-4**) reflects highly negative exposure to environmental and social risks that are largely driven by water stress and weak labor and income, and neutral-to-low governance risks.

Exhibit 4
ESG Issuer Profile Scores

ENVIRONMENTAL	SOCIAL	GOVERNANCE
E-4	**S-4**	**G-2**
Highly Negative	Highly Negative	Neutral-to-Low

Source: Moody's Investors Service

Environmental

The City of Cape Town's exposure to environmental risk (**E-4**) mainly relates to physical climate risk (4) and water management (4). The city's main exposures relate to water shortages. Droughts are the most frequent environmental constraint that directly affect 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 of implementing and maintaining diverse water sources is borne by the city. A recent three-year drought 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

Exposure to social risk (**S-4**) mirrors high labor & income risks (4) as well as high exposure to health and safety risks (4), limited access to basic services (4) and housing shortages (4). The city 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.

Governance

City of Cape Town's governance risk (**G-2**) reflects high data transparency, with all financial statements, along with medium-term budgets, published publicly on the city's and National Treasury's websites. We view improved management policies and practices, which should help the city to maintain sound financial metrics despite significant partly debt funded capital investments.

ESG Issuer Profile Scores and Credit Impact Scores for the rated entity/transaction are available on Moodys.com. In order to view the latest scores, please click here to go to the landing page for the entity/transaction on MDC and view the ESG Scores section.

Rating methodology and scorecard factors

The City of Cape Town's assigned BCA of ba3 is in line with the suggested BCA of ba3. The suggested BCA of ba3 reflects an Idiosyncratic Risk score of 3 (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 5

Cape Town, City of

Regional & 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				**3.50**	**30%**	**1.05**
Operating Margin [2]	3	8.21%	12.5%			
Interest Burden [3]	3	1.76%	12.5%			
Liquidity	5		25%			
Debt Burden [4]	1	14.09%	25%			
Debt Structure [5]	5	21.46%	25%			
Factor 4: Governance and Management				**1**	**30%**	**0.3**
Risk Controls and Financial Management	1					
Investment and Debt Management	1					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**3.03 (3)**
Systemic Risk Assessment						**Ba2**
Suggested BCA						**ba3**
Assigned BCA						**ba3**

[1] Local GDP per capita as % of national GDP per capita
[2] Gross operating balance/operating revenues
[3] Interest payments/operating revenues
[4] Net direct and indirect debt/operating revenues
[5] Short-term direct debt/total direct debt
Source: Moody's Investors Service; Fiscal 2022.

Ratings

Exhibit 6

Category	Moody's Rating
CAPE TOWN, CITY OF	
Outlook	Stable
Baseline Credit Assessment	ba3
Issuer Rating -Dom Curr	Ba3
NSR Issuer Rating	Aa3.za
Senior Unsecured -Dom Curr	Ba3
NSR Senior Unsecured	Aa3.za
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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