MOODY'S INVESTORS SERVICE

CREDIT OPINION
11 November 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	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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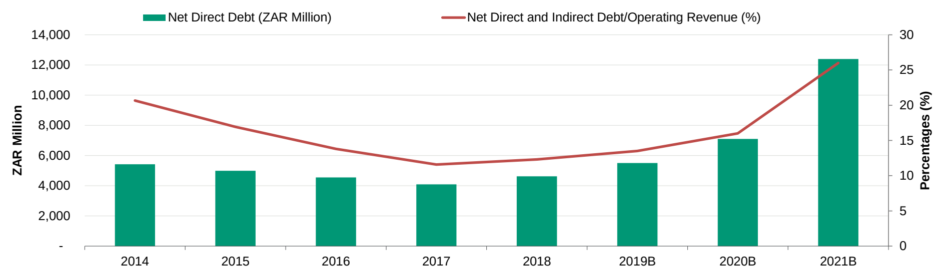
City of Cape Town (South Africa)

Update following change in outlook to negative from stable

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 negative) 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



Sources: City of Cape Town's financials and Moody's Investors Service

Credit strengths

» Favorable financial management, characterized by annual operating surpluses

» 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 the impact of water shortage

Rating outlook

The negative outlook reflects the weakening in the city's support provider, the South African government, taking into account the strong operational and financial links between the two.

Factors that could lead to an upgrade

Given the negative outlook, an upgrade is unlikely at this time. The city's rating could be stabilised if the South African government's outlook were to change from negative to stable.

Factors that could lead to a downgrade

The city's rating could be downgraded in the event of a downgrade of the Baa3 sovereign rating. Additionally, the city's rating could be downgraded if its liquidity and financial performance were to deteriorate.

Key indicators

Exhibit 2

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 (%)	-3.3	-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	1.2	-
GDP per capita as % of National Average	125.7	126.4	120.9	121.7	118.1	-
[1] GDP at provincial level.						

Source: Moody's Investors Service

Detailed credit considerations

On 7 November 2019, we affirmed Cape Town's Baa3/P-3 issuer and debt ratings and changed the outlook to negative from stable. The decision to change the outlook reflects the challenges emanating from the weakening of the sovereign credit profile. 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 Cape Town, expressed in its Baa3 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, characterised annual operating surpluses

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.

ESG considerations

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

Moody's takes 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. In line with the rest of South Africa, its main exposures relate to water shortage. Drought is the most frequent environmental constrain that directly impacts the city's revenue. This 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 for the city.

Social considerations are material to the city's credit profile. Though the economy is large and relatively richer than the national average, the city faces growing demographic-related spending pressure. Demographic pressure is likely to continue to grow 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 faces a high unemployment rate, which directly impacts the ability of the city's residence to pay for services, and increases the number of households that are entirely dependent on the city for basic services. In addition to this, South Africa has one of the highest inequality rates in the world, and this also filters through to the local governments in the country, creating risks of social unrest.

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

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, published in January 2019.

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 (Baa3 negative).

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

Exhibit 3

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**

Fiscal 2019.
Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
CAPE TOWN, CITY OF	
Outlook	Negative
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

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