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Credit Opinion: Cape Town, City of

Global Credit Research - 10 Feb 2014

South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Aa3.za
NSR ST Issuer Rating -Dom Curr	P-1.za
NSR Senior Unsecured -Dom Curr	Aa3.za

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Key Indicators

Cape Town, City of

	2009	2010	2011	2012	2013
Net direct and indirect debt/Operating revenue (%)	27.4	34.2	26.9	22.5	27.0
Interest Payments/Operating Revenue (%)	2.9	3.9	3.7	3.2	3.1
Gross Operating Balance/Operating Revenue (%)	6.8	6.7	9.3	7.7	6.7
Cash Financing Surplus (Requirement)/Total Revenue (%)	-8.9	-5.3	5.0	4.2	-1.0
Intergovernmental Transfer/Operating Revenue (%)	16.0	7.1	7.2	7.6	8.3
Real GDP (% change) [1]	-1.5	3.1	3.6	3.2	-
GDP per capita as % of National Average	129.2	134.3	125.9	124.3	-

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

The City of Cape Town's Aa3.za/P-1.za national scale issuer and debt ratings of the City of Cape Town reflect the city's relatively good budgetary performance and strong liquidity position. The strength of Cape Town's financial position is also supported by the administration's prudent financial policies and the relatively large size and diversification of its economic base. However, the city's ratings are also constrained by the increase in the city's financial leverage in the medium term as a result of the implementation of the city's sizeable capital investment programme.

National Peer Comparison

The City of Cape Town is rated at the high end of the range of South African municipalities rated by Moody's, whose ratings span from Aa3.za to Baa2.za. Cape Town's relative position reflects debt levels that are in line with the median of other metropolitan cities, although these are set to increase. Cape Town compares favourably with the other metros in South Africa in terms of budgetary performance and management , and displays relatively robust cash holdings.

Credit Strengths

Credit strengths for the City of Cape Town include:

- Strong financial position, including robust liquidity, although this is expected to moderate in the medium term

- Prudent financial management

- Moderate debt relative to budget volumes

- Large and diversified economic base

Credit Challenges

Credit challenges for the City of Cape Town include:

- Implementation of its sizeable capital expenditure programme, which will increase financial leverage

- Lingering expenditure pressure for service delivery and social housing

Rating Outlook

The negative outlook on Cape Town's ratings mirrors the negative outlook on South Africa's sovereign rating and reflects systemic pressure.

What Could Change the Rating - Up

A stabilisation of the outlook or an upgrade of Cape Town's ratings will likely require a stabilisation or an upgrade of the sovereign rating.

What Could Change the Rating - Down

Cape Town's rating is likely to follow the trajectory of South Africa's government bond rating. A downgrade of the sovereign rating will likely lead to a downgrade of Cape Town's ratings. Furthermore, Cape Town's ratings would come under pressure in the event of a deterioration in fiscal discipline, resulting in the weakening of its liquidity position and /or a substantial increase in its financial leverage.

DETAILED RATING CONSIDERATIONS

The rating assigned to Cape Town combines the baseline credit assessment (BCA) for the municipality, and the likelihood of extraordinary support coming from the national government in the event that the municipality faced acute liquidity stress.

Baseline Credit Assessment

Cape Town's BCA of baa1 reflects the following factors:

Financial Performance and Debt Profile

Cape Town recorded strong cash in FY2013, enabling the city to increase its cash generated from operations to ZAR6.1 billion, from ZAR5.9 billion in FY2012. Due to the large capital spending undertaken, the city's net cash flow from operating and investing activities amounted to a deficit of ZAR279 million which nevertheless constitute only minus 1% of total revenues. The city's ability to contain operating expenses well within corresponding revenues, enabled it to maintain relatively high levels of gross operating margin to operating revenue ratio at 6.7% in FY2013, despite dropping slightly from 7.7% in FY2012. Nonetheless, its large capex program leads to moderate reduction in liquidity and an increase in the city's borrowing needs in the medium-term.

Based on revenue of ZAR27.4 billion ($2.5 billion) for FY2013, Cape Town is the second-largest city in South Africa. Its operating revenue is underpinned by property tax income and services charges with respect to electricity and water, which collectively constitute 76% of operating revenue and these revenue drivers enabled the city to have a Compound Annual Growth Rate of 15% over the past five years. Operating fiscal transfers grew significantly by 22% to ZAR1.9 billion for FY2013 and have contributed considerably to the city's revenue growth.

Going forward, nonetheless, sector-wide lower tariff hikes of 8% (down from the previous 16%) approved last year by the National Electricity Regulator of South Africa (NERSA) will likely dampen revenue growth.

The City of Cape Town accelerated its capital expenses 40% to ZAR5.9 billion in FY2013. Although reducing capex slightly in 2014-16, the city will still maintain relatively high capital investment of around ZAR5 billion per annum in the medium-term in order to deal with its high service delivery requirements - an inherent challenge for all metropolitan municipalities in the country. Cape Town's total capex of ZAR15.3 billion in 2014-16 will be financed by capital grants (49%), debt (22%) and own funds (29%).

Solid revenue collection rates - averaging 95% in 2012-2013 - have ensured strong cash flows and a strong liquidity ratio of 1.4x for FY2013. Despite the anticipated moderate reduction in liquidity ratio to around 1.2x in 2014-16 - Cape Town will still maintain good cash holding levels of around 27% of its operating expenses, which will be sufficient to cover its opearting costs, including debt service in the medium-term.

The City of Cape Town's debt stock amounted to ZAR6.4 billion or 27% of operating revenues as at 30 June 2013. The city projects to issue debt totalling ZAR3.3 billion in 2015-16 to complement the associated capex of ZAR10.1 billion, with a consequent further increase in financial leverage to 32% by 30 June 2016. Whilst Cape Town's debt exposure does not present a significant credit risk, Moody's will continue to monitor the extent to which the expansive capital program in the medium-term impacts the city's ability to generate adequate cash flow surpluses which are crucial to sustaining sufficient liquidity profile.

Cape Town's debt stock comprises domestic bonds (58%) and bank loans (42%), all denominated in domestic currency and at fixed rates. The average maturity of the city's debt is around 12 years and the bulk (bonds) of the debt is financially secured through sinking funds, which amounted to ZAR0.9 billion for FY2013. Cape Town's interest payments, which absorbed a moderate 3.1% of operating revenues in FY2013, are projected to grow gradually in tandem with debt in the medium term.

Governance and Management

Cape Town's financial governance is focused towards maintaining a financially sound municipality and the administration regularly monitors its budget execution and cash flows and is committed to reinforcing internal controls. As with the previous financial years - the city received an unqualified audit report for the financial year ending 30 June 2013. The city also merited a clean audit with respect to last year's financial performance. Notwithstanding its plans to significantly increase capex, which will increase its financial leverage in medium-term, the city follows prudent financial, debt and liquidity management policies.

Economic Fundamentals

Cape Town is the second-largest city in South Africa. It is the capital city of the Western Cape Province, which is the second-wealthiest province in South Africa after Gauteng, as reflected by higher-than-average levels of income per capita. With around 3.7 million inhabitants, Cape Town makes up roughly 64% of the total provincial population and is the main driver of the Western Cape's economic activity. Nevertheless, the city is also characterised by significant unemployment levels of around 24%, despite being slightly lower than the national average of 25%.

The local economy is evenly diversified, with manufacturing and various business activities in the tertiary sector such as finance, insurance and retail contributing significantly to the GDP of the region. Like Johannesburg in Gauteng Province, Cape Town in Western Cape - drives the provincial economy and consequently its contribution to national economic output is significant. In addition to financial services, port activities and the tourism industry contribute meaningfully to the local output. Situated in one of the world's busiest trade routes, the Port of Cape Town is one of the largest deepwater harbours in Africa and also contributes to the local economy. The tourism industry is regarded as a major growth sector as far as investment, employment and the diversification of services are concerned.

Given their revenue structure and the nature of their expenditure responsibilities, large municipalities in South Africa are exposed to national economic conditions and Cape Town is no exception. Notwithstanding the large and diversified economic bases, large cities experienced cash reductions during the economic recession in 2009.

Institutional Framework

The institutional framework, which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, features moderate financial predictability and stability. The municipal system in South Africa comprises eight metropolitan municipalities (category A), 226 local municipalities (category

B) and 44 district municipalities (category C). The administration system and associated policies are generally consistent and oriented towards enhancing accountability at the local levels; municipal oversight regarding budget approval and monitoring is performed by provincial governments, assisted by the National Treasury.

Spending responsibilities and revenue structures of South African municipalities are difficult to alter due to a consolidated legal framework. The high degree of revenue autonomy enjoyed by metros and large local municipalities - with transfers from the national government accounting for 5-20% of total revenue - compensates for the rigidity of their expenditure profile as a result of their statutory responsibilities (which are chiefly related to the delivery of basic services and municipal infrastructure). Conversely, district and small to medium-sized municipalities - whose primary role is to facilitate, fund and execute infrastructure development in the local municipalities within their jurisdiction - demonstrate moderate-to-high fiscal dependence on government grants. Municipal budgets are sensitive to economic cycles due to the nature of their own revenue sources, which include primarily property taxes and service charges for electricity, water, refuse and sewage. Municipalities are responsible for the collection of local taxes and charges and enjoy the discretion to set tax rates and tariffs. This allows for a moderate degree of revenue flexibility, particularly for metros and large municipalities.

The combination of fiscal transfers and own-source revenues at most metros and local municipalities has proved insufficient to provide the comprehensive range of services required. However, despite these pressures, municipal debt levels have generally remained low to moderate.

Extraordinary Support Considerations

Moody's assigns a moderate likelihood of extraordinary support from the national government reflecting, at the jurisdictional level, Moody's assessment of the national government's policy stance of promoting greater accountability and financial sustainability for South African municipalities. Reputation risk for the central government is deemed modest, mainly in view of the large 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, Moody's recognises 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.

Output of the Baseline Credit Assessment Scorecard

In the case of Cape Town, the BCA matrix generates an estimated BCA of baa2, close to the BCA of baa1 assigned by the rating committee.

The matrix-generated BCA of baa2 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Baa1, as reflected in the sovereign bond rating (Baa1 negative).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in October 2012 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

(BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

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	124.53	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 (%)	3	6.89	12.5%	1.75	30%	0.53
Interest payments / operating revenues (%)	5	3.24	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	27.00	25%			
Short-term direct debt / total direct debt (%)	1	5.70	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						2.03(2)
Systemic Risk Assessment						Baa1
Suggested BCA						baa2

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