

CREDIT OPINION

15 February 2018

Update

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RATINGS

Cape Town, City of

Domicile	Cape Town, South Africa
Long Term Rating	Baa3 , Possible Downgrade
Type	LT Issuer Rating - Dom Curr
Outlook	Rating(s) Under Review

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)

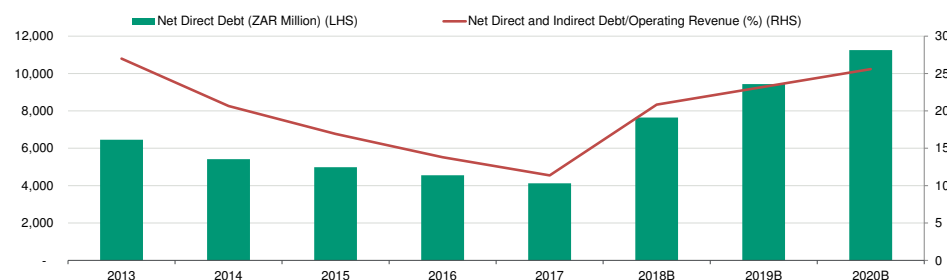
Update to credit analysis

Summary

The credit profile of the [City of Cape Town](#) (Baa3/Prime-3, review for downgrade and Aaa.za/Prime-1.za) reflects the city's stable financial performance, supported by a large and diversified economic base, and predictable sources of revenue from property taxes, electricity and water sales. The city's consistently strong financial performance has enabled it to generate solid operating surpluses, strong liquidity relative to rated peers, and low debt, though we expect this to rise significantly over the next three years. The city's credit profile is constrained by Cape Town's severe water shortages, the result of several years of drought, which will have a direct impact on the city's water revenue, as well as having indirect economic and societal effects. The city has increased its capital spending plans, largely because of spending on water related infrastructure, which will substantially increase its debt.

Exhibit 1

Cape Town's debt is set to increase sharply over the next three years



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

B: City of Cape Town Budget

Credit strengths

- » Favorable financial operations characterized by annual operating surpluses
- » Strong financial and debt management
- » Low debt, though it is set to increase
- » Large and diversified economy base

Credit challenges

- » Increasing capital spending because of water crisis

Rating outlook

The City of Cape Town's rating is currently on review for possible downgrade, mirroring the status of its support provider, the [Government of South Africa \(Baa3/RUR\)](#) which was placed on review for downgrade in November 2017.

Factors that could lead to an upgrade

- » There is little likelihood of an upgrade to Cape Town's global scale rating, as the standalone credit profile is constrained by the sovereign rating.
- » An upgrade of Cape Town's global scale rating would likely require an upgrade of the sovereign rating.

Factors that could lead to a downgrade

- » A downgrade of the sovereign rating would likely lead to a downgrade of Cape Town's ratings.
- » Furthermore, Cape Town's ratings would come under pressure in the event of deterioration in fiscal discipline, resulting in the weakening of its liquidity position and/or a substantial increase in its financial leverage.

Key indicators

Exhibit 2

Cape Town, City of
Year ending June 30 2017

City of Cape Town	2013	2014	2015	2016	2017
Net direct and indirect debt/Operating revenue (%)	27.0	20.7	16.9	13.8	11.4
Interest Payments/Operating Revenue (%)	3.0	3.1	2.6	2.3	2.0
Gross Operating Balance/Operating Revenue (%)	6.7	5.1	13.2	13.0	15.1
Cash Financing Surplus (Requirement)/Total Revenue (%)	-3.2	-7.1	4.7	0.5	0.9
Intergovernmental Transfer/Operating Revenue (%)	8.3	16.3	17.8	17.1	16.1
Real GDP (% change) [1]	2.5	2.0	1.5	-	-
GDP per capita as % of National Average	118.9	115.4	121.0	-	-
[1] GDP at provincial level.					

Source: Moody's Investors Service

Detailed credit considerations

The credit profile of the City of Cape Town as expressed in a Baa3/Aaa.za rating, combines (1) a Baseline Credit Assessment (BCA) of baa3, and (2) a moderate likelihood of extraordinary national government support if the city faced acute liquidity stress.

Baseline Credit Assessment

Favorable financial operations characterized by annual operating surpluses

The City of Cape Town generally exhibits favorable financial operations, averaging a gross operating balance of 11% of operating revenue over 2013-2017. As of 30 June 2017, the city recorded total revenue of ZAR38.4 billion (US\$2.9 billion), the second highest among South African cities, after Johannesburg. The city displays strong revenue generating capabilities, with its own sources contributing 83% of its operating revenue in 2017 fiscal year. Property taxes and service charges dominate its revenue structure, constituting 74% of operating revenue in 2017 fiscal year and helping the city to achieve an average operating revenue growth rate of 11% over the past five years.

That said, the city has broad operating and capital related spending responsibilities, most of which are essential and expensive services, reducing its 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 59% of operating expenditure in fiscal year 2017, ended June 30, 2017, limiting expenditure flexibility.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Strong cash flows enabled the city to finance its capital infrastructure without taking on new debt over the past four years. The city has consistently maintained positive liquidity and cash flows despite financing an increasing proportion of its capital investment from its own funds. The city maintained its strong liquidity ratio of 1.5x in 2017, which is stronger than most of its rated peers in South Africa. The city's strong cash flows were underpinned by its consistently high revenue collection rate of 92% in 2017.

Strong financial management and debt management

The administration regularly monitors its budget execution and cash flows, and is committed to reinforcing internal controls. As in previous financial years, the city received an unqualified audit report for fiscal 2017. Notwithstanding the current water crisis which has prompted the city to increase its capital spending and borrowing in 2018 fiscal year, 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, the second wealthiest province in South Africa after Gauteng, as reflected in 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's economic activity. The local economy is relatively diversified, with manufacturing and various business activities in the tertiary sector, such as finance, insurance and retail, contributing significantly to regional GDP. Cape Town drives 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 local output. Situated on 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. Commercial services is the largest economic sector as far as investments, employment and the diversification of services are concerned.

Low debt, though it is set to increase

The city did not issue any new debt in fiscal 2017. As a result, its net direct debt declined to 11% of operating revenue from 14% the previous year. Its robust cash flows enabled the city to post a marginal cash financing surplus of 0.9% in fiscal year 2017, up from 0.5% in fiscal year 2016. The city funded its entire capital spending for 2017 from transfers and its own funds. Cape Town's debt stock comprises domestic bonds (70%) and bank loans (30%), all denominated in domestic currency and at fixed rates. The average maturity ratio is around 8.8 years and the bulk of the city's debt is financed through bonds, which are secured via sinking fund investments, estimated at ZAR2 billion in fiscal 2017 (this amount is netted off Moody's debt ratios in fiscal 2017). Cape Town's interest payments, which absorbed a moderate 2% of operating revenue in fiscal 2017, compared with 2.3% in 2016, are likely to increase in line with the city's projected borrowing over the next three years.

Increasing capital spending because of water crisis

Challenges associated with the water crisis have prompted the city to increase borrowing for the first time in four years. In July 2017, 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 ZAR21.8 billion on capital infrastructure from fiscal 2018 to fiscal 2020. If it fully implements its capital spending plans, net direct and indirect debt will increase substantially to 26% of operating revenue by fiscal year 2020, from a low 11% in fiscal year 2017. However, the city's projected indebtedness will still be in line with that of other rated metropolitan municipalities in the country. Borrowing will dominate capital infrastructure spending over the next three years, accounting for 42% of the total, while transfers will contribute 29%, own funds 28%, and public contributions and donations only 1%.

The water crisis, which could result in the city having its water supplies turned off in June until the next rainy season, under the so-called "Day Zero" scenario, will have negative consequences for all sectors of the economy, but agriculture will be most affected since it consumes up to 30% of Western Cape Water Supply System per week, which could threaten food supply. In its adjustment budget for fiscal year 2018, the city reduced revenue from water sales to ZAR4.2 billion from ZAR6 billion which is equivalent to a 31% reduction in water revenue, due to a fall in water consumption charges. Cape Town's water crisis could have a more serious effect on the city finances if Day Zero becomes a reality and the taps are turned off, resulting in around 4 million residents having to collect water from 200 water stations across the city. This could also increase operating costs. The city's projected debt exposure does not currently pose a significant credit risk. We will continue to monitor the extent to which the city's expansive medium term capital programme, as well as a potential increase in its operating costs, affects its ability to generate an adequate cash flow surplus and service its outstanding debt.

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 recognise 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

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 standalone 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.

Rating methodology and scorecard factors

The assigned baseline credit assessment BCA of ba1, close to the scorecard indicated BCA of baa3. The matrix generated BCA of baa3 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 Baa3, as reflected in the sovereign bond rating for South Africa (Baa3 RUR).

For details about our ratings approach, please refer to [Rating Methodology: Mapping National Scale Ratings from Global Scale Ratings](#), May 9, 2016.

Exhibit 3

Cape Town, City of

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	131.03	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	14.23	12.5%	1.25	30%	0.38
Interest payments / operating revenues (%)	3	2.17	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	11.40	25%			
Short-term direct debt / total direct debt (%)	1	5.60	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

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
CAPE TOWN, CITY OF	
Outlook	Rating(s) Under Review
Issuer Rating -Dom Curr	Baa3 ¹
NSR Issuer Rating	Aaa.za
Senior Unsecured -Dom Curr	Baa3 ¹
NSR Senior Unsecured	Aaa.za
ST Issuer Rating -Dom Curr	P-3 ¹
NSR ST Issuer Rating	P-1.za

[1] Placed under review for possible downgrade on November 28 2017

Source: Moody's Investors Service

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