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CREDIT OPINION
5 August 2022

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)

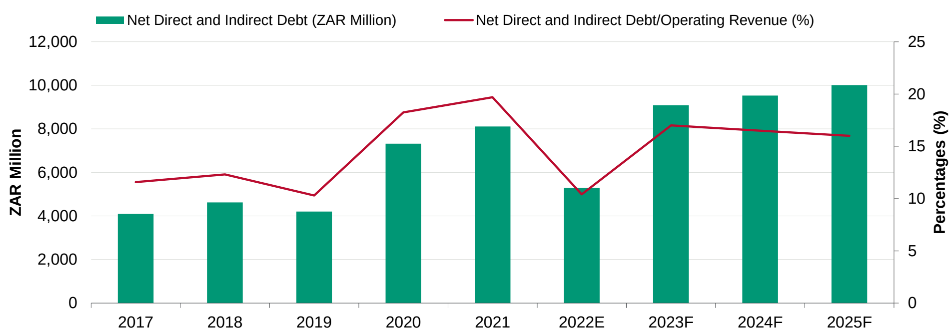
Regular update

Summary

The credit profile of the City of Cape Town (Ba3/NP stable) reflects its moderate financial performance, supported by prudent financial management and a large and diversified economic base. The city has consistently reported robust operating surpluses and strong liquidity, and its debt levels will remain lower than most of its rated peers in South Africa (Ba2 stable) (see Exhibit 1). The city's credit profile is constrained by capital spending pressures and a structurally weak economic environment. 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 remain lower than most of its rated South African peers



Fiscal year ending 30 June.
E: Estimate
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 to address social and environmental risks

Rating outlook

The outlook is stable, mirroring the drivers of the stable outlook for South Africa. We expect the city's recently implemented tariff strategy to lead to sustainable revenue collections, resulting in modest operating performance in the medium term.

Factors that could lead to an upgrade

A rating upgrade is unlikely, considering the stable outlook assigned to the city. We would consider changing the ratings if the city displayed consistently improving and robust 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 further downgrade of the ratings if the city experiences significant deterioration in operating performance and liquidity. We would also consider a rating downgrade if the sovereign were downgraded.

Key indicators

Exhibit 2

City of Cape Town

	2017	2018	2019	2020	2021	2022 E	2023 F	2024 F	2025 F
Net direct and indirect debt/Operating revenue (%)	11.6	12.3	10.3	18.2	19.7	10.4	17.0	16.5	16.0
Interest Payments/Operating Revenue (%)	2.1	2.1	1.8	2.0	2.0	1.5	1.7	1.6	1.6
Gross Operating Balance/Operating Revenue (%)	15.0	15.5	17.7	6.8	1.2	6.6	4.5	5.2	6.1
Cash Financing Surplus (Requirement)/Total Revenue (%)	0.9	3.3	7.1	0.6	-2.0	-3.6	-3.4	-3.1	-2.8
Intergovernmental Transfer/Operating Revenue (%)	16.5	17.1	17.4	12.4	14.0	11.1	11.9	12.3	12.7
Real GDP (% change) [1]	1.2	0.8	-	-	-	-	-	-	-
GDP per capita as % of National Average	118.1	118.1	-	-	-	-	-	-	-
[1] GDP at provincial level.									

[1] GDP at the provincial level.
Fiscal year ending 30 June.
E: Estimate
F: Forecast
Source: Moody's Investors Service

Detailed credit considerations

The City of Cape Town's credit profile reflects its resilient operating performance and liquidity. Although we forecast the operating surplus to moderate, due to operating environment structural challenges, the city's cash position will remain resilient, over the medium term. Low debt levels, together with the city's liquidity reserves, place the city in a favourable position to raise funding. 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

During fiscal 2020, the city's council approved a new tariff strategy, where the energy tariffs charged to residents are to be increased at a lower rate than that imposed by Eskom (Caa1 negative). This was done to ensure 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 new strategy resulted in an increase in the revenue collection rate to 98% in fiscal 2021, from 95% in fiscal 2020. Though the new strategy also resulted in a significant decline in the city's gross operating balance (GOB) of 1.2% of operating revenue in fiscal 2021, the GOB for fiscal 2022 increased to an estimate of 6.6% of operating revenue- indicating a robust collection rate against well contained operating expenditures.

Property taxes and service charges were the primary drivers of the city's operating revenue, amounting to an estimated 66% 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

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capacity has ensured that the city maintains robust operating performance during the past 5 fiscal years. With the recently 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 approximately 54% of operating expenditures according to fiscal 2022 estimates, 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 (2017-2021). Rising fuel prices- and thus increased inflation- are expected to push up bulk purchase costs- weighing on operating expenditures in the medium term.

Though we expect rising fuel prices to weigh on operating expenditures, and do not anticipate changes in the city's inflexible operating expenditure structure over the next three fiscal year, we expect the city to maintain moderate gross operating surpluses in the medium term- resulting from high collection rates, with forecasts indicating an average GOB/operating revenues of 5.2% during fiscal 2023-25.

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 2021. However, operating environment structural challenges will add some pressure to the city's overall performance in the next three fiscal years, although the city continues to follow prudent financial management policies.

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 estimates. Although we expect the liquidity position to remain resilient over the medium term, the upcoming bond repayments together with the shift of investments from short-term products to long-term products, shall result in a forecasted average cash ratio of 0.7x between fiscal 2023-25.

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 very low at 10.4% (with the sinking fund netted off total debt) of operating revenues according to fiscal 2022 estimates. Though the city has upcoming bond repayments in the medium term, the city's medium term capital spending plans indicate additional long-term borrowing- albeit still remaining at low levels. During this time (2023-2025) NDID is forecast to average 16.4% of operating revenues.

The city's short-term debt has risen significantly during the past few years (6.1% of total direct debt in fiscal 2020 and 19.3% in fiscal 2021), reaching an estimated 23.3% of total direct debt for fiscal 2022. This is because the city has bond repayments (which shall be covered by the sinking fund) of approximately ZAR4.2bn (approx. 50% of total debt) due in the medium term (2023-2025). These will therefore be shifted from long-term borrowing to short-term borrowing over the medium term thus pushing up short-term debt.

Cape Town's debt stock currently comprises of 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, estimated at ZAR3 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. This shall therefore result in a significant change of the city's long-term debt composition, with bonds forecast to fall to 1% of total borrowings by fiscal 2025, from 73% in fiscal 2021.

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 major CAPEX projects (averaging 18% of operating revenue between 2023-2025) include upgrading the IT system used- as the current product approaches maturity; 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.

The rising need for capital spending was reflected in the estimated cash financing requirement of 3.6% of total revenues, according to fiscal 2022 estimates. With the increased capital spending needs, we expect the cash financing requirement to remain over the medium term, averaging a forecasted 3.1% 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

CAPE TOWN, CITY OF's ESG Credit Impact Score is Highly Negative CIS-4

Exhibit 3

ESG Credit Impact Score

CIS-4

Highly Negative

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 is highly negative (**CIS-4**), reflecting 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

Source: Moody's Investors Service

Environmental

The City of Cape Town's highly negative exposure to environmental risk, reflected in its **E-4** issuer profile score, 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 is highly negative (**S-4** issuer profile score), mirroring 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

We assess the City of Cape Town's governance issuer profile score as neutral-to-low (**G-2** issuer profile score). Data transparency is high, with all financial statements, along with medium-term budgets, published publicly on the city's and National Treasury's websites.

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 BCA of ba3 generated by the scorecard. The scorecard-indicated BCA of ba3 reflects an Idiosyncratic Risk score of 4 (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**	**30%**	**0.90**
Operating Margin [2]	3	5.13%	12.5%			
Interest Burden [3]	3	1.97%	12.5%			
Liquidity	5		25%			
Debt Burden [4]	1	19.69%	25%			
Debt Structure [5]	3	19.29%	25%			
Factor 4: Governance and Management				**5**	**30%**	**1.50**
Risk Controls and Financial Management	1					
Investment and Debt Management	5					
Transparency and Disclosure	1					
Idiosyncratic Risk Assessment						**4.08 (4)**
Systemic Risk Assessment						**Ba2**
Scorecard-Indicated BCA Outcome						**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 2021.

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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