

CREDIT OPINION

6 April 2020

Update

 Rate this Research

RATINGS

Cape Town, City of

Domicile	Cape Town, South Africa
Long Term Rating	Ba1
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)

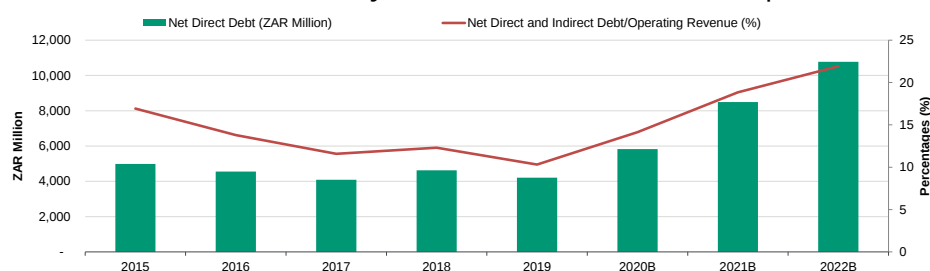
Update following rating downgrade to Ba1

Summary

The [City of Cape Town's](#) (Ba1/NP negative) credit profile reflects its strong financial performance, supported by: (1) prudent financial management; (2) large and diversified economic base; and (3) predictable revenue sources from property taxes and service charges. The city has consistently reported an operating surplus, strong liquidity compared to its peers in [South Africa](#) (Ba1 negative) and low debt, although we expect debt to rise over the next three years due to the city's focus on increasing the resilience of its water infrastructure following the 2018 water crisis. The city's credit profile is constrained by capital spending pressure due to: (1) water shortage from drought; (2) infrastructure backlogs; and (3) population growth. The coronavirus outbreak and the associated deterioration in the global and national economic outlook will also likely constrain the city's financial performance through lower revenue collection as a result of higher unemployment.

Exhibit 1

Debt will increase over the next three years, but remain lower than that of its peers



Fiscal year ending 30 June.

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

Credit strengths

- » Favourable financial performance, characterised by annual operating surpluses
- » Strong financial and debt management practices
- » Large and diversified economic base

Credit challenges

- » Rising debt level, but will remain lower than that of South Africa's other metros
- » Increasing capital spending pressure to improve water infrastructure to mitigate the impacts of drought

Rating outlook

The negative rating outlook reflects the weakening credit profile of the city's support provider, the South African government, taking into account their strong operational and financial links.

Factors that could lead to an upgrade

Given the negative outlook, an upgrade is currently unlikely. The city's rating outlook could be changed to stable if the outlook on the South African government's rating 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 Ba1 sovereign rating. Additionally, it could be downgraded if its liquidity and financial performance were to deteriorate.

Key indicators

City of Cape Town							
	2013	2014	2015	2016	2017	2018	2019
Net direct and indirect debt/Operating revenue (%)	27.0	20.7	16.9	13.8	11.6	12.3	10.3
Interest Payments/Operating Revenue (%)	3.0	3.1	2.6	2.3	2.1	2.1	1.8
Gross Operating Balance/Operating Revenue (%)	6.7	5.1	13.2	13.0	15.0	15.5	17.5
Cash Financing Surplus (Requirement)/Total Revenue (%)	-3.2	-7.1	4.7	0.5	0.9	3.3	7.1
Intergovernmental Transfer/Operating Revenue (%)	8.3	16.3	17.8	17.1	16.5	17.1	17.2
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.							

Fiscal year ending 30 June.

Source: Moody's Investors Service

Detailed credit considerations

On 1 April 2020, we downgraded the City of Cape Town's global scale ratings to Ba1/NP from Baa3/P-3 and maintained the negative outlook. The downgrade of the city's ratings reflects the challenges emanating from the weakening of the sovereign credit profile. We view the centralised nature of the regional and local government (RLG) sector in South Africa and the close financial links between the national government and the RLGs as the factor that keeps the city's ratings at par with the sovereign bond rating. 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 the City of Cape Town, as expressed in its Ba1 rating, combines: (1) a Baseline Credit Assessment (BCA) of ba1; and (2) a low likelihood of extraordinary support from the national government in the event that the city faces acute liquidity stress.

Baseline Credit Assessment

Favourable financial performance, characterised by annual operating surpluses

The City of Cape Town's financial performance is generally favourable, with its gross operating balance averaging 15% of operating revenue over fiscal 2015-19. For the fiscal year ended 30 June 2019, the city recorded total revenue of ZAR42.9 billion (\$3.2 billion), the second highest among South African cities after [Johannesburg](#) (Ba1 negative). We expect the city's financial performance over the next three years to remain strong, but a little lower than in the past, with an average gross operating balance of 7.2% of operating revenue over fiscal 2020-22. The city has strong revenue-generating capacity, with its own-source revenues contributing 82% of its operating revenue in fiscal 2019. Own-source revenues will likely contribute the same proportion, on average, over the three years starting fiscal 2020. Property taxes and service charges will remain the primary contributors to the city's operating revenue, averaging 73% of operating revenue in the next three fiscal years (2020-22). This will help the city to achieve an average operating revenue growth rate of 6% over this 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. Fixed items such as bulk purchases and employee costs

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accounted for 63% of the city's operating expenditure in fiscal 2019, limiting expenditure flexibility. We do not expect changes to the operating expenditure structure over the next three years, with fixed items contributing 63%, on average, to operating revenue each year.

Strong financial and debt management practices

The administration regularly monitors its budget execution and cash flows, and is committed to reinforcing internal controls. As in previous fiscal years, the city received an unqualified audit report for fiscal 2019. Despite challenges associated with the water crisis, the city managed to maintain its operating performance and post a strong gross operating balance of 17.5% as a percentage of operating revenue in fiscal 2019, compared with 15.5% in fiscal 2018. 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 four million inhabitants, Cape Town makes up roughly 64% of the total provincial population and is 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. 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 deep water harbours in Africa. Commercial services is the largest economic sector in terms of investments, employment and the diversification of services.

Rising debt level, but will remain lower than that of South Africa's other metropolitan municipalities

The city issued new debt of only ZAR196 million in fiscal 2019. As a result, its net direct debt decreased to 10% of operating revenue from 12% in fiscal 2018. Its robust cash flow enabled the city to post a cash financing surplus of 7.1% in fiscal 2019, up from 3.3% in fiscal 2018. Cape Town's debt stock comprises domestic bonds (77%) and bank loans (23%), all denominated in the 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 ZAR2.5 billion in fiscal 2019 (this amount is netted off our debt ratios in fiscal 2019). Cape Town's debt is set to increase to fund its increasing capital spending. The city plans to borrow ZAR1.1 billion in fiscal 2020, ZAR3 billion in fiscal 2021 and a further ZAR3 billion in fiscal 2022. If the city fully implements its capital spending plans, its net direct debt will increase to ZAR10.8 billion by fiscal 2022, with net direct and indirect debt as a percentage of operating revenue rising to 22%. The increase in borrowing will also result in an increase in interest payments as a percentage of operating revenue to 2.7% in fiscal 2022 from 1.8% in fiscal 2019. However, the city's projected debt will still be in line with that of South Africa's other rated metropolitan municipalities.

The city's consistently strong liquidity will help to ease pressures from rising debt. Cape Town has consistently maintained strong cash flows, which supports its robust liquidity profile (a liquidity ratio of 2.2 times as of the end of fiscal 2019). Cape Town's liquidity is likely to remain strong despite the city's intention to fund a large part of its capital spending in the next three years from own funds.

Increasing capital spending pressure to improve water infrastructure to mitigate the impact of water shortages

Challenges associated with the water crisis have prompted the city to increase borrowing to fund capital spending. 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 approximately ZAR29 billion on capital infrastructure over fiscal 2020-22.

Although the city managed to alleviate the water crisis – through various methods of demand reduction and water augmentation projects – it still plans to further invest in its water infrastructure to try to avoid another crisis. The city has outlined and budgeted for a number of projects aimed at diversifying water sources to be implemented over the next 10 years. Of the total capital spending budget for fiscal 2020-22, 34% in fiscal 2020, 42% in fiscal 2021 and 43% in fiscal 2022 is earmarked for water-related infrastructure. Although the city's debt levels are likely to increase over the next three years as a result of the increase in capital spending, its debt will remain lower than that of its rated South African peers.

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

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

We take 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. Similar to the rest of South Africa, the city's main exposures relate to water shortages. Drought is the most frequent environmental constraint that directly affects 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 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.

Social considerations are material to the city's credit profile. Although 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 rise 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 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. We also view the coronavirus outbreak as a social risk under our ESG framework, given the impact for public health and safety in the City of Cape Town.

Governance considerations are material to Cape Town's credit profile. The city's strong administration has implemented 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, although the treasury plays an oversight role. Data transparency is very high, with all financial statements, along with medium-term budgets, published publicly on the city and national treasury's websites.

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](#).

Rating methodology and scorecard factors

The assigned BCA of ba1 is similar 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 Ba1, as reflected in the sovereign bond rating of South Africa.

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

Exhibit 3

City of Cape Town**Regional and Local Governments****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	3	118.10	70%	2.4	20%	0.48
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	16.57	12.5%	1.25	30%	0.38
Interest payments / operating revenues (%)	3	1.93	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	10.30	25%			
Short-term direct debt / total direct debt (%)	1	6.40	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						2.16(2)
Systemic Risk Assessment						Ba1
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	Ba1
NSR Issuer Rating	Aaa.za
Senior Unsecured -Dom Curr	Ba1
NSR Senior Unsecured	Aaa.za
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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