Credit Opinion: Zdar nad Sazavou, City of

Global Credit Research - 06 Apr 2010

Czech Republic

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa1.cz

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Key Indicators

Zdar nad Sazavou, City of

	2005	2006	2007	2008	2009
Net Direct and Indirect Debt/Operating Revenue (%)	29.01	21.47	17.29	7.07	5.25
Debt Service/Total Revenue (%)	6.39	5.31	5.27	6.03	2.64
Gross Operating Balance/Operating Revenue (%)	24.71	15.46	14.22	19.62	10.65
Cash Financing Surplus (Requirement)/Total Revenue (%)	34.41	-13.65	-12.87	31.89	-11.15
Intergovernmental Transfers/Operating Revenue (%) [1]	61.18	59.55	68.15	68.79	70.01
Self-Financing Ratio	1.00	0.63	0.62	1.00	0.59
Capital Spending/Total Expenditure (%)	24.67	32.69	29.83	23.08	24.74

[1] Intergovernmental transfers = current transfers + shared taxes

Opinion

SUMMARY RATING RATIONALE

The national scale issuer rating (NSR) of Aa1.cz assigned to the City of Zdar nad Sazavou primarily reflects the city's good financial performance, substantial cash reserves and very low debt levels. The rating also takes into account uncertain shared tax revenue expectations for 2010, which may put pressure on the city's operating budget. However, thanks to conservative budgeting, its operating performance should remain positive and will likely recover to pre-crisis levels in 2011.

The rating remains constrained by the financial framework for regional and local governments (RLGs) in the Czech Republic, under which municipalities enjoy only limited control over and flexibility relating to their operating revenue and expenditures.

National Peer Comparison

The national scale ratings of Czech municipalities span from Aa1.cz to Aa2.cz, the latter being represented by just one issuer. As such, Zdar nad Sazavou's Aa1.cz rating does not differ from the majority of NSRs of Czech municipalities; however, it varies in terms of the baseline credit assessment measure (see below). The city's position relative to national peers reflects its below average debt and debt service levels. The city's gross operating balance (GOB) is in line with the average for other Aa1.cz rated cities.

Credit Strengths

Credit strengths for Zdar nad Sazavou include:

Good financial and operating performance

High cash reserves, providing a financial cushion for investment in the medium term

Low debt levels

Credit Challenges

Credit challenges for the city include:

Pressures arising from uncertain shared tax revenue expectations for 2010

Limited control over operating revenue and expenditure under the current fiscal framework

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

An upward movement in the rating is unlikely in the medium term.

What Could Change the Rating - Down

Abrupt and sustained deterioration in the city's operating performance or a major increase in the stock of debt could place pressure on the city's finances and have a negative impact on the current rating.

DETAILED RATING CONSIDERATIONS

The rating assigned to the City of Zdar nad Sazavou reflects the application of Moody's Joint-Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the city and then considers the likelihood of support coming from the national government to avoid an imminent default by the city, should this extreme event ever occur.

Baseline Credit Assessment

Zdar nad Sazavou's BCA was revised to 6 from 7 in April 2010 reflecting that the city has been able to maintain strong financial characteristics despite the impact of the economic crisis on its operating revenue in 2009. The BCA of 6 (on a scale of 1-21, where 1 represents the lowest credit risk) reflects the following factors:

Financial Position and Performance

Zdar nad Sazavou posted a sound operating performance in 2005-08, which was largely based on the city's conservative budgetary management and a sustained growth in tax revenue. The GOB averaged at 19% of the city's operating revenue during the period.

In 2009, its GOB fell to a five year minimum but still solid 11% of operating revenue, impacted largely by an unprecedented fall in shared taxes of almost 17%, which became evident in the budget only by mid-2009. Operating revenue fell by 10%, while operating expenditure remained at 2008 levels. The city initiated some cost-cutting measures during the second half of the year to slow an expansion in operating spending. Revenue expectations for 2010 are relatively conservative and further cost savings were introduced, particularly in transfers to municipal organisations and in its own operations. Nevertheless, the operating margin is unlikely to significantly improve in 2010, with a gradual recovery in GOB expected in 2011.

Zdar nad Sazavou's financial performance in 2005-2009 has been positive on average (almost 6% of total revenue), albeit volatile. Both in 2005 and in 2008, the privatisation of municipal housing stock led to high surpluses, which exceeded 30% of total revenues. This helped the city to accumulate substantial cash reserves averaging 70% of operating revenue in 2005-2009.

In 2009, cash reserves represented 75% of the city's operating revenue, the majority of which was not earmarked. The city currently holds around 30% of its liquidity in bank accounts and earmarked monetary funds. The remainder has been distributed to several asset managers, which are permitted to invest only in low-risk securities with a maximum average maturity of two years.

Accumulated cash reserves are intended to be increasingly drawn to fund the city's five-year investment plan. In addition, they will have to offset weaker operating margins in funding capex, which will add to anticipated financing deficits going forward. With the help of grants applied for from the EU, capex should continue to represent a significant share of close to 30% of total expenditure in the next three years. In 2005-09, the city's investments varied between 23% and 33% of total expenditure and were focused mainly on the improvement of technical networks, road infrastructure, schools and sports facilities.

Debt Profile

Zdar nad Sazavou's net debt is very low (5% of operating revenue) and should not significantly increase in 2010 (it is expected to remain below 7% of operating revenue). Debt fell from almost 30% operating revenue beginning in 2004 and has been more than fully covered by cash.

The city's last bank loan was drawn in 2007. It plans to take a minor loan of 3% of operating revenue (CZK15 million) on purchase of a cultural centre in 2010. Further loans are not anticipated.

The city's debt structure has been relatively simple, with medium- to long-term amortising bank loans denominated in local currency, mostly at fixed interest rates. Excluding bank loans, almost half of the debt stock in 2003-07 was formed by advance rents from lessees of the city's housing stock. This part of the debt sharply decreased due to the vast privatisation of flats in 2008 and will cease in 2010.

The city does not have any guarantees or any other contingent liabilities. Nevertheless, to face potential pressures in the operating budget due to a slump in shared tax revenue, the city opened an overdraft of CZK12.5 million in 2009, which it will keep also for 2010.

Governance and Management Factors

The city has a strong track record of meeting its budgetary targets, which has been enhanced by stable management. Prudent fiscal management is supported by comprehensive and transparent financial reporting, including medium-term budget forecasts and an investment plan. Moody's also considers Zdar nad Sazavou's experience regarding debt management as limited, given the simple structure of its debt (in line with that of the majority of Czech RLGs).

Economic Fundamentals

The City of Zdar nad Sazavou has almost 23,000 inhabitants and is situated in the Vysocina Region located in the centre of the Czech Republic. The city's population has gradually decreased since 1997as migration outflows have exceeded birth rates. The downward population trend is expected to continue going forward, driven by suburbanisation and migration to bigger cities, although the city is trying to combat this through housing development efforts.

The majority of the work force is employed in the service industry, but the city has traditionally had above average employment in the industrial sector. Aside from engineering and metallurgy, the most important industries are metalworking, automotive and electro-technics. The city also benefits from the proximity of the Jamska industrial zone, situated in the south-eastern part of the city. The unemployment rate in Zdar nad Sazavou district increased from 6% in 2008 to more than 10% in 2009, reflecting the impact of the economic recession. Its peak should be reached within 2010 and a downward trend is likely in 2011.

The economic performance of the Vysocina Region is below the average of other regions of the Czech Republic. Vysocina's share of national GDP was around 4.2% and the GDP per capita reached about 85% of the national average in 2008.

Moody's believes the local economic environment will have only a limited effect on the city's creditworthiness. Under the institutional and financial framework for Czech RLGs, local economic fundamentals do not directly influence their budgets, which are, instead, almost entirely tied to the national economy. Therefore, the current downturn in the national economy weighs on the city's revenues through lower-than-expected proceeds from shared taxes, which is likely to persist until 2011.

Operating Environment

The operating environment for Czech RLGs reflects that of OECD emerging-market economies, with relatively high GDP per capita, modest GDP volatility and a relatively high ranking on the World Bank's Government Effectiveness Index. The combination of these characteristics suggests a low level of systemic risk, as reflected in the A1 rating assigned to the Czech Republic.

Institutional Framework

The framework for Czech municipalities, which began to take shape in the mid-1990s, has been relatively predictable. Moreover, the fundamentals of the system have been stable and are unlikely to be substantially changed in the medium term.

The Czech economy declined by more than 4% in 2009, which when compared with average annual growth of 5.4% over 2005-2008, brings about a challenging reduction in tax revenue for municipalities. In 2009, the decrease in shared taxes reached 14% year-on-year, which constitutes a significant shock for Czech cities, especially as it brings a rather abrupt end to recently buoyant revenue growth.

2010 will be another challenging year for municipalities, as they will be forced to adjust their budgets to uncertain revenue conditions associated with the dynamics of an economic recovery and the potential time lag before it would support a resurgence in tax revenue. Such an unprecedented situation for Czech municipalities will test their ability to adapt to constrained conditions despite their low budgetary flexibility. Nevertheless, some cuts appear feasible, especially in terms of capital spending and (in the short term) the operating side of budgets. Moody's believes potential challenges will be eased by municipalities' comparatively low debt and comfortable cash cushions accumulated in previous years.

Czech municipalities generally enjoy only limited budgetary flexibility. Most of their operating revenues are either shared taxes collected at the national level or operating-related transfers from the central government. This leaves municipalities with only marginal taxation power and a limited ability to tap into wealth generated by the local economic environment. The tax base and tax rate of all taxes are set by the central government. City-controlled fees are capped and are often already set at their maximum legal threshold. Cities' potential use of the real estate tax, whereby they can multiply the basic tax calculation on real estate by up to 5x (since 2009), remains very politically sensitive.

The ability of municipalities to influence operating expenditure is also constrained, in that it largely consists of services that cities are obliged to provide under national law. Additionally, salaries of civil servants and the level of social benefits provided to citizens are set by the central government. Therefore, local governments can only contain growth in current expenditure by restructuring administrative costs, reallocating staff resources, streamlining the education sector or making other organisational and administrative changes. Municipalities have a degree of spending flexibility over capital expenditure, which constituted 29% of its total expenditure in 2008. However, it should be noted that part of capex is usually devoted to infrastructure maintenance and works in progress, and is closely linked to EU co-funded projects, limiting flexibility on the capital side.

Investments have been the main driver of the development of municipal debt. The stock of municipal direct debt in the Czech Republic is relatively low (33% of operating revenues in 2008) and has been relatively stable over 2005-2008. Nevertheless, indebtedness is expected to grow slowly in the medium term, given pressure to upgrade the municipal infrastructure to EU standards. Debt service should remain manageable at least in the medium term, given that cities' debt repayment capacity has not yet been depleted. While the central government has no set regulations limiting the total debt burden at the municipal level, debt service is limited to 30% of current revenues as assessed by the central government. This regulation potentially provides significant room for debt growth, as the average debt service of the municipalities was 5% of operating revenues in 2008.

Extraordinary Support Considerations

Moody's assigns a moderate likelihood of extraordinary support from the central government, reflecting the central government's promotion of greater accountability for Czech cities. The limited system of oversight implemented by the central government also suggests a policy favouring non-intervention. Finally, reputation risk issues for the central government appear to be modest given the cities' debt structure, which relies more on bank loans than bonds.

Moody's also assigns a very high level of default dependence between the municipality and the central government, reflecting a heavy reliance on central government resources, in the form of either shared taxes, which are determined and collected nationally and redistributed on a per capita basis, or transfers from the state budget.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Zdar nad Sazavou, the BCA scorecard (presented below) generates an estimated BCA of 6, which is in line with the BCA assigned by the rating committee.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard 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 judgements regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Score card 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 the scorecard cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.

The Moody's Global Scale rating for issuers and issues in local currency 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.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's Baseline Credit Assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the Baseline Credit Assessment reflects the likelihood that a local government would require extraordinary support.

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%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can materially change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Zdar nad Sazavou, City of

Baseline Credit Assessment Scorecard - 2008	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
Factor 1: Operating Environment						
National GDP per capita (PPP basis, $US)	24,444	6	50.0%	6.00	60.0%	3.60
National GDP Volatility (%)	6.6	9	25.0%			
National Govt Effectiveness Index (World Bank)	1.07	3	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.01	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	15	15	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	7.5	7.5	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	0.3	1	33.3%	1.67	7.5%	0.13
Cash Financing Surplus(Req)/Total Revenue (%)	12.6	1	33.3%			
Gross Operating Balance/Operating Revenue (%)	17.5	3	33.3%			
Net Working Capital/Total Expenditures						
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	7.1	1	50.0%	2.25	7.5%	0.17
Short-Term Direct Debt/Direct Debt (%)	27.5	6	25.0%			
Net Debt/Operating Revenue Trend	-34.3	1	25.0%			
Factor 5: Governance & Management						
Fiscal Management	1	1	40.0%	2.30	7.5%	0.17
Investment & Debt Management	7.5	7.5	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated ($US)	20,840	6	100.0%	6.00	7.5%	0.45
Estimated BCA						**6**