MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
22 March 2017

Rate this Research

RATINGS

Belgrade, City of

Domicile	Serbia
Long Term Rating	Ba3
Type	LT Issuer Rating - Fgn 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.

Contacts

Gjorgji Josifov 420-221-666-340
AVP-Analyst
gjorgji.josifov@moodys.com

Massimo Visconti 39-02-9148-1124
VP-Sr Credit Officer
massimo.visconti@moodys.com

Belgrade, City of

Update Following Recent Rating Upgrade

Summary Rating Rationale

The City of Belgrade's Ba3 issuer rating reflects (1) its track record of prudent budgetary management mirrored in sound operating surpluses and good financial performance; (2) its adequate liquidity position; and (3) its important role in the national economy as a capital city of Serbia.

Conversely, the City of Belgrade's rating is constrained by the city's relatively high but declining debt levels and high infrastructure needs. The limited revenue and expenditure control under the current legislative framework also mitigates the credit positives.

On 20 March 2017, Moody's upgraded the issuer rating of the City of Belgrade to Ba3 from B1, following Moody's upgrade of Serbia's government bond rating to Ba3 from B1 on 17 March 2017. The main drivers of the rating actions are (1) the strengthening of Serbia's credit profile as captured by the upgrade in the sovereign government bond rating as Belgrade has close macroeconomic and financial linkages with the central government; and (2) Belgrade's track record of solid financial performance, which Moody's expects to continue in the medium-term.

National Peer Comparison

Moody's currently rates three cities in Serbia whose ratings span from B1 to Ba3. Belgrade's Ba3 rating reflects its greater institutional capacity and revenue raising capability than the cities of Novi Sad (Ba3, stable) and Valjevo (B1, stable). Belgrade and Novi Sad's fiscal management practices are comparatively stronger than Valjevo's. In addition, Belgrade features larger balance sheet and budget volumes, as well as a large and dynamic economic base. These credit strengths are however offset by higher debt and debt-service levels.

Credit Strengths

» prudent budgetary management, as reflected by sound operating margins

» good financial performance although under pressure from significant investment requirements ahead and city's owned companies

» improved and adequate liquidity position

» good governance and management practices

» crucial role in the national economy

Credit Challenges

» high but declining and manageable debt levels

» limited revenue and expenditure control under current framework

Rating Outlook

The rating outlook is stable

Factors that Could Lead to an Upgrade

» Upward pressure on the rating of Belgrade could arise from (1) an upgrade of the sovereign rating or (2) the city's ability to maintain its sound operating surpluses and comfortable liquidity position.

Factors that Could Lead to a Downgrade

» Downward pressure on the rating could result from (1) a downgrade of Serbia's sovereign rating; (2) a material deterioration in the city's operating and financial performance or (3) a material increase in its debt exposure.

Key Indicators

Exhibit 1

Belgrade, City of

	2012	2013	2014	2015	2016
Net Direct and Indirect Debt/Operating Revenue (%)	71.27	90.41	101.18	84.90	63.77
Debt Service/Total Revenue (%)	7.98	10.23	8.78	9.19	9.71
Gross Operating Balance/Operating Revenue (%)	19.87	15.40	11.50	12.00	15.75
Cash Financing Surplus (Requirement)/Total Revenue (%)	-7.39	3.37	3.02	6.72	5.86
Intergovernmental Transfers/Operating Revenue (%)	0.15	0.23	3.66	0.17	0.28
Self-Financing Ratio	0.79	1.16	1.20	1.54	1.37
Capital Spending/Total Expenditure (%)	32.04	21.99	15.84	13.41	16.95

Source: Belgrade, City of; Moody's

Detailed Rating Considerations

Belgrade's Ba3 rating combines (1) the baseline credit assessment (BCA) of ba3, and (2) a strong likelihood of extraordinary support coming from the national government in the event that the entity face acute liquidity stress.

Baseline Credit Assessment

PRUDENT BUDGETARY MANAGEMENT, AS REFLECTED BY SOUND OPERATING BALANCES

Belgrade's fiscal performances have been sound, with double-digit operating surpluses recorded over the last five years. In 2016, the city's gross operating balance-to-operating revenue ratio improved to 16% from 12% at year-end 2015 thanks to (1) the estimated 2.8% national GDP growth (the highest rate of growth over the past 8 years), which translated into 7% growth of the proceeds of shared taxes, coupled with an increase of 3% of property tax and local fees; and (2) slower growth in operating expenditures. Moody's expects this trend to continue in 2017-18, attributable to positive growth prospects of Serbian economy with expected economic growth of 3.0% this year and 3.3% in 2018.

The majority of Belgrade's operating revenue is made of shared taxes and local taxes and fees, altogether representing more than 70% of operating revenue in 2016. Proceeds from PIT as the major component of shared taxes amounted RSD33.3 billion in 2016, accounting for 87% of shared taxes or 42% of operating revenues. Local taxes and fees comprised 20% of operating revenues in 2016 and grew by more than double over the last 3 years, mainly driven by the increase of property tax collection. This improvement is in line with the city's administration tax efforts started in 2014, which aimed to widen property tax basis and expand the number of tax payers.

After flat growth of operating expenditures in 2013-14, the city's operating expenditures grew by 13% in 2015 and another 16% in 2016. It reflected larger requirements in the areas of goods and services as well as transfers paid to the city's owned utility companies, both comprising around 56% of operating expenditures. The personnel cost remained at similar levels to last year, consuming 15% of operating expenditure.

GOOD FINANCIAL PERFORMANCE ALTHOUGH UNDER PRESSURE FROM SIGNIFICANT INVESTMENT REQUIREMENTS AHEAD AND CITY'S OWNED COMPANIES

Sound operating margins combined with regular cash flow and prudent capital investment resulted in a good self-financing capacity, which allowed the city to post consecutive financing surpluses between 3%-7% of total revenues between 2013 and 2016, compared with a financing deficit of 18% and 7% recorded in 2011 and 2012 respectively. Regardless the capital expenditures increased to 17% of total expenditure from 13% in 2015, the financing results remained positive at 6% of total revenue. In 2017-18, the city envisages significant increase of capital expenditures ranging between 28% and 30% of total expenditures compared with 17% on average during 2013-16.

Although the planned increase in capital expenditure has the potential to weaken city's financial performance and gradually deplete its cash reserves, we expect that Belgrade's financing results will remain in positive territory, reflecting the city's willingness to revise its investment strategy in case of need, as witnessed in the recent past. In addition, the city's sound operating surpluses will partially support the investment activities. The City of Belgrade's capital investment plan for 2017-18 envisages numerous extensive projects, focusing mostly on urban and transportation infrastructure, including the construction of new bridges and tunnels, extension of sewage system and reconstruction of water supply network.

Belgrade's spending also comes from subsidies and transfers to its owned companies (15% of total expenditures in 2016), which play an active role in providing core public services. Belgrade provides various services through its 31 majority-owned companies and affiliates. However, the active role played by city-owned companies should contain the operating expenditure pressure going forward.

IMPROVED AND ADEQUATE LIQUIDITY POSITION

A track record of good financial performance has led to a comfortable liquidity position in the last few years. Belgrade's accumulated cash reserves strengthened in 2016, averaging 13% of operating revenue (RSD10 billion) compared with 11% in 2015. We expect that the city's cash position will remain adequate and stable at around RSD10 billion throughout 2017, covering 1.4x of debt service costs falling due in 2017 and will sufficiently manage the projected debt repayments in the medium term.

The available cash represents an extremely solid financial cushion against potential budgetary pressures and in support of capex funding in the medium term. The cash balance is even during the year without appreciable fluctuations and is not likely to considerably vary in the near term.

GOOD GOVERNANCE AND MANAGEMENT PRACTICES

Belgrade's sound governance and management practices, as well as clearly defined internal policies and procedures, have supported the city's operations. The City of Belgrade consistently provides comprehensive financial documents in compliance with legislative requirements.

Belgrade's management has pursued prudent budgetary and investment policies. During difficult crisis years as well as in 2013-14 when the city faced challenging operating environment, Belgrade's administration was able to impose efficient cost-cutting measures to adjust operating expenditures to limited revenues. Although 2015-16 brought some relief for the city's finances, which should continue in 2017, the planned huge investment activities represent challenge for Belgrade's administration. On the back of the developing financial and institutional framework of local governments in Serbia, these issues will further test the quality of Belgrade's fiscal management in the medium term.

Fiscal discipline is enhanced by strict rules from the state treasury, which the city is accountable to. Financial performance is supported by gradually evolving and improving financial reporting. While its budgetary reports are both comprehensive and transparent.

CRUCIAL ROLE IN THE NATIONAL ECONOMY

The City of Belgrade plays an important role in the national economy as Serbia's capital and most developed city. The local economy is dynamic and much more diversified than other Serbian cities, limiting its exposure to economic cycles. The city is of central strategic importance to the Serbian economy and it is the country's largest economic hub, accounting for about 39% of national GDP.

With 1.7 million residents, accounting for approximately 24% of Serbia's population in 2015, Belgrade is the country's largest labour market. Belgrade's relative affluence is evident in its GDP per capita, which is 70% above the national average. Belgrade is the seat of the central government and hosts the country's main universities and the headquarters of the largest companies.

HIGH BUT DECLINING AND MANAGEABLE DEBT LEVELS

Belgrade's direct debt further declined to 57% of operating revenue in 2016 from 76% in 2015 and historical high 87% at year-end 2014. According to current projections, Moody's expects the city's debt to decline to 51% of operating revenue by end of 2017 following the city's commitment to fund the majority of its investment programme from the operating margin, asset sale or central government transfers.

Belgrade's direct debt (RSD44.8 billion at year-end 2016) is consisted of bank loans of which (1) RSD27.4 billion loans with EIB; (2) RSD13.6 billion with EBRD, and (3) RSD3.8 billion with domestic banks. Bank loans were used for modernization of transportation, public roads and streets, construction of a new bridge over the Sava river, rehabilitation of water supply and sewage network, and modernization of social and housing infrastructure.

When adding the indirect debt exposure, which is fully represented by the city's owned non self-supporting transportation company, the net direct and indirect debt (NDID) amounted RSD50.4 billion in 2016, an equivalent of 64% of operating revenue compared with 85% in 2015 and high 101% in 2014. Moody's notes that the city of Belgrade has not provided any guarantee for any debt issued by its owned companies. Moody's expects that the city's debt will further decline as indicated in the official budget for 2017 with NDID-to-operating revenue ratio reaching 57% of operating revenue.

Despite rising debt between 2011-2014, Belgrade's debt service costs remained in check at 9.7% of total revenue in 2016 (9.2% in 2015). Moody's regards Belgrade's debt burden as manageable and expects its debt service to remain at around 9% in 2017. Moody's assumption reflects the city's favourable direct debt maturity profile, which comprises long-term amortising loans. We expect the Belgrade's interest expenses on borrowings to drop to around 1.3% of operating revenue in 2017 compared with 2.1% in 2016 and 3.1% in 2015.

A high 92% of Belgrade's direct debt was denominated in euros at year-end 2016, making the city's debt more vulnerable to exchange-rate fluctuations.

LIMITED REVENUE AND EXPENDITURE CONTROL UNDER CURRENT FRAMEWORK

The institutional framework features low financial predictability and stability. Belgrade has relatively limited control over its revenue base, with shared taxes consisting about half of its operating revenue taxes in 2016). In fact, municipal local tax revenues represent a minor proportion of municipal revenue (20% in 2016). This fiscal dependence on state resources exposes city's finances to the performance of the central government budget and evolving intergovernmental relations.

Partially mitigating this lack of discretionary powers on the tax revenue side, the framework attributes a greater revenue rising capacity related to the city's local taxes and fees compared to other local governments in Serbia. We do not expect that the composition of Belgrade's operating revenue will significantly differ in 2017-18, although the changes in the Law on income tax could will have some minor negative implications on the city's finances. Local finances in Serbia depend on the decisions of the central government, leaving the local governments with limited leeway with regard to taxes.

The spending flexibility of Belgrade is also limited as 71% of its operating expenditure is made of highly inflexible expenses, including personnel costs, the purchase of goods and services and transfers to city owned companies. Any maneuverability would lie in cuts to administrative and costs and in some non-obligatory transfers. The capex remains a major leeway for Belgrade, although it is curbed by high infrastructure needs, common for all Serbian local governments.

Extraordinary Support Considerations

The strong likelihood of extraordinary support from the national government reflects Moody's assessment of the strategic importance of Belgrade to the Serbian economy.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Belgrade, the BCA matrix generates an estimated BCA of b1, close to the BCA of ba3 assigned by the rating committee.

The matrix-generated BCA of b1 reflects (1) an idiosyncratic risk score of 4 (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 Ba3, as reflected in the sovereign rating (Ba3 stable).

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

Exhibit 2

Rating Factors

Belgrade, City of						
Baseline Credit Assessment	**Score**	**Value**	**Sub-factor Weighting**	**Sub-factor Total**	**Factor Weighting**	**Total**
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	167.56	70%	1	20%	0.20
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	9		50%	8	20%	1.60
Financial flexibility	7		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	1	13.64	12.5%	2.25	30%	0.68
Interest payments / operating revenues (%)	3	2.74	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	63.80	25%			
Short-term direct debt / total direct debt (%)	3	15.80	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**3.98(4)**
Systemic Risk Assessment						**Ba3**
Suggested BCA						**b1**

Source: Moody's

Ratings

Exhibit 3

Category	Moody's Rating
BELGRADE, CITY OF	
Outlook	Stable
Issuer Rating	Ba3

Source: Moody's Investors Service

REPORT NUMBER 1065478

MOODY'S
PUBLIC SECTOR EUROPE