MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
26 October 2016

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RATINGS

Belgrade, City of

Domicile	Serbia
Long Term Rating	B1
Type	LT Issuer Rating - Fgn Curr
Outlook	Positive

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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Belgrade, City of

Serbia

Summary Rating Rationale

The City of Belgrade's B1 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 the capital city of Serbia.

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

National Peer Comparison

Moody's currently rates three cities in Serbia whose ratings span from B2 to B1. Belgrade's B1 rating reflects its greater institutional capacity and revenue raising capability than the cities of Novi Sad (B1, positive) and Valjevo (B2, positive). Belgrade's 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 high investment needs and city's owned companies

» Improved and adequate liquidity position

» Good governance and management practices

» Crucial role in the national economy

Credit Challenges

» High although declining and manageable debt levels

» Limited revenue and expenditure control under current framework

Rating Outlook

The rating outlook is positive and it mirrors the outlook on Serbia's sovereign rating, reflecting the close macroeconomic, financial and institutional linkages between the sovereign and the sub-sovereigns in Serbia.

Factors that Could Lead to an Upgrade

» Upward pressure on the rating of Belgrade could arise from an upgrade of the sovereign rating associated with 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 a downgrade of Serbia's sovereign rating

» A material deterioration in the city's operating and financial performance

» A material increase in its debt exposure

Key Indicators

Exhibit 1
Key Indicators
Belgrade, City of

	2011	2012	2013	2014	2015
Net Direct and Indirect Debt/Operating Revenue (%)	65.66	71.27	90.41	101.18	84.90
Debt Service/Total Revenue (%)	6.05	7.98	10.23	8.78	9.19
Gross Operating Balance/Operating Revenue (%)	23.62	19.87	15.40	11.50	12.00
Cash Financing Surplus (Requirement)/Total Revenue (%)	-17.56	-7.39	3.37	3.02	6.72
Intergovernmental Transfers/Operating Revenue (%)	5.99	0.15	0.23	3.66	0.17
Self-Financing Ratio	0.64	0.79	1.16	1.20	1.54
Capital Spending/Total Expenditure (%)	41.29	32.04	21.99	15.84	13.41

Source: Belgrade, City of

Detailed Rating Considerations

Belgrade's B1 rating combines (1) the baseline credit assessment (BCA) of b1, 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 2015, the city's gross operating balance-to-operating revenue ratio stood at 12% in line with the performance in 2014, which is still below the average of 22% recorded between 2011-12. The deterioration of the operating performance was driven by the exposure of the operating margins to a low-revenue-growth environment in 2013 and 2014. In particular, changes in the Law on Local Finances in 2012 have led to elimination of some city's charges and fees in 2012-13, and changes in the Law on Income Tax in 2013 along with the drop of 1.8% of the national economy in 2014 have led to reduced proceeds of income tax. However, the City of Belgrade has consistently shown a capacity to emerge in relatively sound financial shape.

In 2016-17, Moody's expects Belgrade's operating margin to improve to 14% and 16% of operating revenue respectively, attributable to combined effect of (1) the positive national economic growth prospects, which will translate into growing proceeds of shared taxes, coupled with increased collection of property tax and own-source non-tax revenues; and (2) slower growth in operating expenditures.

The majority of Belgrade's operating revenue is made of shared taxes and local taxes and fees, altogether representing around 80% of operating revenue in 2015. Proceeds from PIT as the major component of shared taxes amounted RSD32 billion in 2015, accounting for almost 90% of shared taxes or 49% of operating revenues. Local taxes and fees comprised 23% of operating revenues in 2015 and grew by more than 85% over the last two 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 and continued last year, 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. 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 50% of operating expenditures. The personnel cost also increased by 6% in 2015, consuming 18% of operating expenditure.

GOOD FINANCIAL PERFORMANCE ALTHOUGH UNDER PRESSURE FROM HIGH INVESTMENT NEEDS 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 2015, compared with a financing deficit of 18% and 7% recorded in 2011 and 2012 respectively. In 2016-17, the city envisages an increase of capital expenditures to 21% and 27% of total expenditures respectively compared with 17% on average during 2013-15.

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 2016-17 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 (16% of total expenditures in 2015), 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 significantly strengthened in the first three quarters of 2016, averaging 17% of operating revenue (RSD10.7 billion) compared with 11% in 2015. We expect that the city's cash position will remain adequate and stable at around RSD10 billion throughout 2016 and 2017, covering 1.5x 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 brought some relief for the city's finances, which should continue in 2016-17, 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 ALTHOUGH DECLINING AND MANAGEABLE DEBT LEVELS

Belgrade's direct debt declined to 76% of operating revenue in 2015 from historical high 87% at year-end 2014. We expect the city's debt to gradually 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 (RSD49.2 billion at year-end 2015) is consisted of bank loans of which (1) RSD26.4 billion loans with EIB; (2) RSD16.5 billion with EBRD, and (3) RSD6.3 million 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 RSD55.1 billion in 2015, an equivalent of 85% of operating revenue compared with 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 adjustments for 2016 with NDID-to-operating revenue ratio reaching 63% of operating revenue, a trend which should continue throughout 2017 when the city's debt stock should drop to 58%.

Despite rising debt between 2011-2014, Belgrade's debt service costs remained in check at 9.2% of total revenue in 2015 (8.8% in 2014). Moody's regards Belgrade's debt burden as manageable and expects its debt service to remain at around 9% in 2016-17. 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 2% of operating revenue in 2016 compared with 3.1% in 2015 and 3.5% in 2014.

A high 87% of Belgrade's direct debt was denominated in euros at year-end 2015, 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, which consists mainly of shared taxes (55% in 2015). In fact, municipal local tax revenues represent a minor proportion of municipal revenue (23% in 2013). 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 2016-17, although the planned changes in the Law on income tax could potentially 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 72% 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, in line with the BCA of b1 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 B1, as reflected in the sovereign rating (B1 positive).

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.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

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%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Methodology and Scorecard Factors

Exhibit 2
Rating Factors
Belgrade, City of

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	167.57	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	11.43	12.5%	3	30%	0.90
Interest payments / operating revenues (%)	5	3.39	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	5	84.90	25%			
Short-term direct debt / total direct debt (%)	3	14.30	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						4.2(4)
Systemic Risk Assessment						B1
Suggested BCA						b1

Source: Belgrade, City of

Ratings

Exhibit 3

Category	Moody's Rating
BELGRADE, CITY OF	
Outlook	Positive
Issuer Rating	B1

Source: Moody's Investors Service

REPORT NUMBER 1047462

MOODY'S
PUBLIC SECTOR EUROPE