MOODY'S INVESTORS SERVICE

Credit Opinion: Gothenburg, City of

Global Credit Research - 13 May 2016

Sweden

Ratings

Category	Moody's Rating
Outlook	Stable
Senior Unsecured	Aaa
Commercial Paper	P-1
Other Short Term	(P)P-1

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Key Indicators

Gothenburg, City of (Unconsolidated)

	2011	2012	2013	2014	2015
Net direct and indirect debt / operating revenue (%)	8.5%	10.7%	12.2%	9.0%	10.5%
Gross interest expenses / operating revenue (%)	5.0%	4.6%	3.6%	2.9%	1.6%
Gross operating balance / operating revenue (%)	5.6%	4.0%	4.0%	3.9%	3.0%
Cash financing surplus (requirement) / total revenue (%)	-3.9%	5.2%	22.0%	-1.5%	-0.2%
Intergovernmental revenues / total revenue (%)	5.2%	5.1%	5.1%	5.5%	6.9%

Opinion

SUMMARY RATING RATIONALE

The Aaa long-term debt rating with stable outlook and P-1 short-term rating of the City of Gothenburg reflects the city's strong financial position underpinned by a track record of positive gross operating balances, a supportive institutional framework, Gothenburg's role as an industrial hub and its current low net debt levels. The rating also takes into account our expectation that the city will borrow more in coming years in order to finance investments required to provide services and infrastructure to a growing population.

Credit Strengths

Credit strengths for the City of Gothenburg include:

- Robust financial performance, albeit with declining positive gross operating balances

- Strong institutional framework with established equalisation system

- Gothenburg's economic strength as an industrial and transport hub

- A currently low level of net debt, although expected to increase

Credit Challenges

Credit challenges for the City of Gothenburg include:

- Growing population to put pressure on required investment funded by increased debt

- Refinancing risk due to debt structure and reliance on short term borrowing

- Large city owned company sector forecasted to increase although control has been enhanced through modified corporate governance guidelines

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Down

A loosening of the prudent budget discipline, resulting in a significant increase in expenditure and operating deficits could exert pressure on the credit. Additionally, a significant increase in investment levels and consequently debt burden and/or city owned companies seizing to contribute dividends to the city could also put downward pressure on the rating. Although not expected, a weakening of the importance of local government and consensus with the central government regarding the delivery of public services, or a downgrade of the sovereign rating could place the rating under pressure.

DETAILED RATING CONSIDERATIONSs

Gothenburg's Aaa rating combines (1) a baseline credit assessment (BCA) for the entity of aa1 and (2) a very high likelihood of extraordinary support coming from the national government in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

ROBUST FINANCIAL PERFORMANCE, ALBEIT WITH DECLINING GROSS OPERATING BALANCES

The City of Gothenburg has a solid track record of financial performance. The gross operating balance (GOB) has consistently been positive, averaging 4.1% of operating revenues over the last five years. However, this budget surplus has been declining since peaking in 2013 at 4% and falling to 3% in FY2015 (SEK 1.1 billion). This negative trend is expected to continue, with increasing population and the need for public services putting pressure on the City's GOB. Budget forecasts suggest that in 2016, Gothenburg will run a balanced budget, although we expect the city to outperform their budget and deliver a small operating surplus.

In 2015, operating revenues were SEK36.1billion, an increase of 4.4% from 2014 largely driven by increased tax revenues. The bulk of Gothenburg's revenues stems from local taxes, which accounted for 75% of operating revenues in 2015. Intergovernmental transfers, in the form of tax equalisation grants make up 7%, with the remainder of revenues coming from fees and commissions and financial income from city-owned companies. The breakdown of operating revenue has remained largely unchanged over the past five years.

In 2015, operating expenses were SEK35.0 billion, an increase of 5.3% from 2014. About half of operating expenses consist of personnel costs. The remainder includes: costs of goods and services (30%); interest expenses (2%); and transfers for financial assistance (3%).

STRONG INSTITUTIONAL FRAMEWORK WITH ESTABLISHED EQUALISATION SYSTEM

Local governments have unlimited power of taxation and are deemed to have strong revenue and expenditure flexibility. Due to their constitutional position, local governments cannot be declared bankrupt and are fully liable for all obligations they enter into. Since 2000, the requirements for a Balanced Budget have been applied, and any resulting deficits must be corrected within three years. Ultimately, the Swedish state is responsible for ensuring equality in the provision of public services in the country; it therefore closely monitors the municipal sector and annual budgets. The annual balanced budget analysis has concluded that Gothenburg has fulfilled this requirement in 2015 with net earnings, excluding capital gains of SEK 379 million and a third of net earnings have been transferred to the earnings equalisation reserve.

As is the case for most municipalities in Sweden, Gothenburg receives a grant under the Swedish equalisation system. In 2015, equalisation grants were SEK3.42 billion, a 4% increase from the year before. General grants were SEK2.5 billion in 2015, a 31% increase from the previous year of SEK1.9 billion, and includes the additional state grant in support of the rising public expenditure due associated with the increase in refugees. Prior to 2015, grants remained relatively stable over the last five years. These raised government grant levels provide some assistance towards the financial costs of the services associated with the 2,500 new arrivals with residence permits and an additional 6,000 asylum seekers. It must be noted however that after 2020, these raised grant levels will revert back to pre-refugee inflow levels and municipalities are expected to allocate internal funding to support the continued integration of refugees.

Gothenburg's strong and stable financial performance is supported by a mature and highly developed institutional framework. The division of powers between national, county and municipal governments is clearly defined under acts of the Riksdag. Changes have at times been significant, with responsibilities shifted within levels of government after a process of extensive and meaningful consultation between all levels of government and the Swedish Association of Local Authorities and Regions (SALAR). The local government financing principle is enshrined within government policy so that responsibilities may not be shifted without provision of appropriate resources. Local governments have a critical role in carrying out almost 40% of public primary expenditures and account for approximately 20% of GDP.

GOTHENBURG'S ECONOMIC STRENGTH AS AN INDUSTRIAL AND TRANSPORT HUB

Gothenburg is considered the transport hub of Scandinavia, Sweden's major industrial centre and home to some of Sweden's largest companies, including Volvo, Stena and SKF. Given that three-quarters of the city's revenues come from local taxes, the strength of the regional economy supports the city's finances. The city's unemployment rate stood at 8.4% in 2015 and has been declining for the last four years despite being marginally higher than the national average (7.8%).

Gothenburg is the second largest city in Sweden with a population of over 548,000 inhabitants, approximately 5.5% of the national total. Gothenburg has seen a steady increase in its population and this trend is expected to continue over the next years. This growth will increase demand for public services, requiring further investments, which we expect to be partially debt financed. The current low levels of debt could allow Gothenburg to withstand higher levels without a material impact on credit worthiness.

CURRENTLY LOW LEVELS OF NET DEBT, ALTHOUGH EXPECTED TO INCREASE

Net direct and indirect debt are calculated at 10.5% (SEK 3.7 billion) of operating revenues (SEK 36.1 billion) at year end 2015, slightly above the 9% (SEK 3.1 billion) recorded in the previous year. Gothenburg currently has low net debt levels because while the city borrows on behalf of city-owned companies, we perceive company on-lending as self-supporting debt. We consider any debt as self-supporting as long as the debt taken on behalf of city-owned companies can be serviced by those companies. This debt is currently judged as self-supporting due to the companies' strong track record of positive contributions after tax and interest payments. Despite a one-off SEK 850 million write down of GoBiGas' non-current assets in 2015, the overall contribution of city-owned companies was SEK 363 million.

Gothenburg's Aaa rating relies on this self-supporting assumption. When including all contingent liabilities, including on-lent self-supporting debt and guaranteed debt, total direct and indirect debt would reach SEK 43 billion, equivalent to 119% of operating revenues in 2015 (2014: 125%). The largest self-supporting, city-owned borrowers are Förvaltnings AB Framtiden (SEK 15 billion), Göteborg Energi AB (SEK 4.9 billion), and HIGAB (SEK 3.7 billion).

We expect that Gothenburg will assume more debt in the coming years in order to support raised investment levels as they aim to provide the necessary services for their growing population. Higher debt levels related to raised investment levels could lead to higher interest costs for the city owned companies and this could compromise Gothenburg's Aaa rating if the companies do not maintain their strong financial performance and net positive contributions. We will closely monitor the companies' net financial positions moving forward.

Gothenburg's funding comes primarily through an EMTN programme, certificate programmes and an ECP programme, together with credit lines from several Nordic large financial institutions. Additional loans include those from the European Investment Bank and Kommuninvest (Aaa), a funding vehicle for the local government sector in Sweden.

In addition, Gothenburg was the first city to issue a green bond and has issued three green bonds since 2013 raising a total of SEK 3.36 billion. Proceeds have been allocated to various green initiatives, including sustainable transportation, housing, and energy efficiency. These issuances were able to attract a wider range of investors to the city's investor base and the city plans to tap the green bond market again in June 2016.

REFINANCING RISK AND RELIANCE ON SHORT TERM BORROWING

SEK 7.53 billion of the Municipality's loans will mature in 2016, equivalent to 25% of total direct debt (SEK 29.5 billion). We consider this to be a high level of debt maturing in any single year and consider that this debt structure exposes the city to market risk. This has allowed the city to benefit from the current low and even negative interest rate environment. However, internal policy limits refinancing risk by requiring that no more than 35% of total external debt and 25% of long term external debt can mature within 12 months. In March 2016, the average duration of their long term debt maturing was 4.14 years, a positive increase from 3.2 years in December 2015. The existing debt maturity profile falls in line with internal guidelines, recommending that the average maturity of long-term loans should fall between two and six years. Despite this positive trend towards longer debt tenure, we still consider Gothenburg's existing debt structure as relatively short dated compare to other European municipal borrowers.

Mitigating the refinancing risk is a strong liquidity position and policy requirement that the city should hold committed secured facilities that will cover at least 12 month of debt coming due. Despite being short on cash (SEK 1.4 billion), the city holds committed bank facilities amounting to SEK 9 billion. Moody's views that this coverage policy adequately balances the refinancing risk related to the relatively short dated debt issued by the city.

GROWING POPULATION TO PUT PRESSURE ON REQUIRED INVESTMENT AND DEBT LEVELS

The city has grown by over 10% in the last decade to 548,000 inhabitants at the end of 2015 primarily through migration and immigration. This population growth is exerting pressure on sectors such as housing, education, health care and transportation. To address these pressures, Gothenburg is involved in large projects including the West Swedish Agreement and other infrastructure investments. The West Swedish Agreement is anticipated to cost SEK 34 billion and will be co-financed between the state, regions (Västra Götaland and Region Halland) and Gothenburg City along with income from congestion tax in Gothenburg. To enable the local development plans, the city will need to invest in infrastructure and public service (Schools, kindergartens etc.)

Over the next four years, 2016-2019, the city projects an increase in its capital investments to reach SEK20.5 billion. This is more than twice the amount invested between 2012-2015 (SEK 9.3 billion). We expect Gothenburg's realised investment to be lower than the projected levels due to political nonalignment associated with a minority government in combination with a prudent vetting process. In addition, the city companies are expected to invest SEK 30 billion between 2016-2019 which we expect to be largely financed via increased debt levels. We will continue to monitor the municipal and city company investments and consequent debt issued and expect this to be managed appropriately moving forward.

LARGE CITY OWNED COMPANY SECTOR FORECASTED TO INCREASE ALTHOUGH CONTROL HAS BEEN ENHANCED THROUGH MODIFIED CORPORATE GOVERNANCE GUIDELINES

The city-owned company sector is already large and is expected to grow further due to the aforementioned anticipated investments by the city owned companies between 2016-2020. The investment in the city owned companies will peak in 2020 with new investments by city-owned companies expected at SEK8.6bn. Göteborgs Stadshus AB (Stadshus AB) is the parent company of all the wholly and part-owned companies. If we include all the contingent liabilities, in the form of self-supporting debt on-lent to the city owned companies; this debt is reported at SEK43 billion and would equal 119% of operating revenues in 2015. We anticipate this number to increase following the anticipated investments.

In 2015 the city has on-lent SEK26.5 billion or 90% of its direct debt (SEK 29.6 billion) to companies controlled by the city. In addition, the indirect debt which was issued independently by the companies was reported at SEK8.9 billion. Förvaltnings AB Framtiden, a property company, represents the majority of this debt, as they have SEK5.8 billion in outstanding debt, equal to 65% of the city's indirect debt. We anticipate the amount of indirect debt reducing over the next 5 years as city owned companies are no longer allowed to issue new independent own named debt under the modified corporate governance guidelines.

The modified corporate governance guidelines apply to all city owned companies and aim to centralise all financing functions for both the City Authority and the city's companies. Since 2013 financing for these companies has taken place through the city with the city on-lending and charging market interest rates to these companies. As a result of this move to bring financing in-house, the city's direct debt increased to SEK29.6 billion in 2015 from SEK22.8 billion in 2013 while indirect debt issued independently by the companies decreased to SEK8.9 billion in 2015 from 17 billion in 2013; the city's net debt, however, has not been affected by this change as we view company owned debt as self-supporting.

With the consolidation of the companies and treasury functions we believe transparency and control over the city's liabilities has increased. The city's centralised financial functions are also likely to improve risk control, giving the city greater control of these city-owned companies. This is a credit positive in an environment of a large company sector anticipated to grow further.

Extraordinary Support Considerations

We assign a very high likelihood of extraordinary support from the Kingdom of Sweden (Aaa stable), reflecting our assessment of (1) the role of Gothenburg as a major population centre and driver of the economy; (2) the central governments oversight of the regional and local government sector; (3) local governments are required to close budget deficits within three years; (4) the Swedish equalisation system; and (5) Sweden's reputation would suffer if Gothenburg were to experience financial distress.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Gothenburg, the BCA matrix generates an estimated BCA of aa1, in line with the BCA of aa1 assigned by the rating committee.

The matrix-generated BCA of aa1 reflects (1) an idiosyncratic risk score of 2 (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 Aaa, as reflected in the sovereign bond rating (Aaa 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 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 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

National and Global Scale Ratings

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in May 2016 entitled "Mapping National Scale Ratings from Global Scale Ratings".

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

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 Factors

Gothenburg, City of

Baseline Credit Assessment Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals						
Economic strength	5	100.00	70%	3.8	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	2	20%	0.40
Financial flexibility	3		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	5	3.40	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	3	2.26	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	10.50	25%			
Short-term direct debt / total direct debt (%)	5	25.45	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						2.29(2)
Systemic Risk Assessment						Aaa
Suggested BCA						aa1

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