

Global Credit Research - 24 Jul 2014

Sweden

### Ratings

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

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### Key Indicators

#### Gothenburg, City of (Unconsolidated)

	2009	2010	2011	2012	2013
Net direct and indirect debt / operating revenue (%)	15.0%	9.4%	8.5%	11.4%	9.6%
Gross interest expenses / operating revenue (%)	3.2%	2.7%	5.0%	4.6%	3.6%
Gross operating balance / operating revenue (%)	2.2%	6.9%	5.6%	4.0%	4.0%
Cash financing surplus (requirement) / total revenue (%)	-4.4%	-3.7%	-3.9%	5.1%	22.0%
Intergovernmental revenues / total revenue (%)	5.4%	5.6%	5.2%	5.1%	5.1%

\*Cash financing surplus in 2013 was largely affected by changes in working capital

### Opinion

#### SUMMARY RATING RATIONALE

The Aaa long-term debt rating with stable outlook and P-1 short-term rating of the City of Gothenburg reflect the city's strong financial position underpinned by a track record of balanced budgets and a supportive institutional framework, Gothenburg's role as an industrial hub and its current low 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 to a growing population.

#### Credit Strengths

Credit strengths for the City of Gothenburg include:

- Robust financial performance, with stable positive gross operating balances
- Strong institutional framework with established equalisation system
- Gothenburg's economic strength as an industrial hub
- A currently low level of net debt, although expected to increase

## **Credit Challenges**

Credit challenges for the City of Gothenburg include:

- Growing population is likely to put pressure on debt levels as the city invests in order to provide services
- Contingent liability of the city-controlled companies' debt though changes in corporate structure will result in greater control

## **Rating Outlook**

The rating outlook is stable.

## **What Could Change the Rating - Down**

A downgrade is currently unlikely given the stable outlook. However, a loosening of the prudent budget discipline, resulting in a significant increase in expenditure and negative operating margins, in combination with a high level of debt-financed investments, could put pressure on the ratings. A material weakening in the financial position including a significant increase in the debt burden and/or contingent liabilities could also put downward pressure on the rating. Additionally, although not expected, a significant 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 CONSIDERATIONS**

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 faced acute liquidity stress.

### **Baseline Credit Assessment**

#### **ROBUST FINANCIAL PERFORMANCE, WITH STABLE POSITIVE GROSS OPERATING BALANCES**

The City of Gothenburg has a solid track record of stable financial performance. Over the last five years (2009-2013), the gross operating balance (GOB) has consistently been positive, averaging 4.5% of operating revenues. In 2013, the GOB was SEK33.2 billion, or 4% of operating revenues. The financing surplus excluding extraordinary items affecting comparability (such as repayment of insurance premiums) was SEK728 million in 2013 (2.2% of total revenues), up from SEK596million in 2012 (1.8% of total revenues).

The bulk of Gothenburg's revenues stems from local taxes, which accounted for 74% of total revenues in 2013. Intergovernmental transfers make up 5% and the balance comes from fees and commissions, financial income from city-owned companies and other sources. These percentages have remained almost unchanged over the past five years.

Operating expense allocations have also remained relatively stable. About half of operating expenses derive from personnel costs. The remainder consists of: other expenses including costs for goods and services (42%); interest expenses (4%); and transfers (4%). In 2013, total expenses were SEK32.6 billion, slightly higher than in 2012 (SEK31.7 billion).

Over the last five years (2009-2013), total expenses have grown at a slightly lower rate than total revenues (compound annual growth rate of 2.2% vs 2.5%, respectively), supporting the posting of positive operating balances. For 2014, the city's budget anticipates a slowing of revenue and expense growth, to roughly the same rate (1.9%). This would result in a positive operating margin of roughly 3%, slightly lower than the last few years. Swedish municipal elections will be held in on the 14 September 2014, along with Swedish County Councils and the Swedish Parliament elections. While a draft 2015 Budget has been released, we expect further details on revenues and spending to be finalised towards the end of the year. Nevertheless, we expect that Gothenburg will continue its track record of solid operating performance.

#### **STRONG INSTITUTIONAL FRAMEWORK WITH ESTABLISHED EQUALISATION SYSTEM**

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.

Local governments have unlimited power of taxation and the ability to charge to meet costs for services. 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 the socio-economic balance in the country; it therefore monitors the municipal sector.

As is the case for most municipalities in Sweden, Gothenburg receives a grant under the Swedish equalisation system. In 2013, equalisation grants were SEK3.1 billion, similar to the year before. General grants were SEK1.7 billion in 2013, in line with 2012 and remaining relatively stable over the last five years. These government grants provide a measure of stability against any volatility in the local economy.

#### GOTHENBURG'S ECONOMIC STRENGTH AS AN INDUSTRIAL AND TRANSPORT HUB

Gothenburg is the second largest city in Sweden with a population of over 533,000, approximately 5% of the national total. It 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 9.4% in 2013, slightly higher than the national average (8.5%). Gothenburg saw a substantial increase in the announced lay-offs within the transportation industry at the end of 2008 and the beginning of 2009, but after peaking at 10% in 2010, the unemployment rate has since declined.

Gothenburg has seen a steady increase in its population and this trend is expected to continue (discussed below). This robust growth will increase demand for public services, requiring further investments, which we expect to be partially debt financed. We believe Gothenburg is in a strong position to assume more debt because of its currently low level.

#### A CURRENTLY LOW LEVEL OF NET DEBT, ALTHOUGH EXPECTED TO INCREASE

In 2013, the city's direct debt stock increased marginally to SEK22.9 billion (69% of operating revenues), from SEK21.7 billion (67% of operating revenues) in 2012, as the city was able to finance its investments through tax revenues and investment income. We expect, however, that Gothenburg will assume more debt in the coming years in order to invest to provide services to a growing population (discussed below). Higher debt levels are, however, unlikely to compromise Gothenburg's Aaa rating because its net debt levels are currently low. Net direct and indirect debt declined to 9.6% of operating revenues at end 2013 from 11.4% the year before. Gothenburg has low net debt levels because the city borrows on behalf of city-owned companies and some city-owned companies borrow in their own name, which we consider financially self-supporting. If we were to consider all the self supporting debt from the companies, gearing would be much higher (gross direct and indirect debt to operating revenues measured 129% at end 2013).

Gothenburg's funding comes primarily through its EUR6 billion MTN programme and SEK6 billion CP programme. It also has a USD500 million ECP and loans such as from the European Investment Bank and Kommuninvest, a specialised lender. In 2013, Gothenburg issued green bonds through its EMTN programme, the first in the Nordic countries to do so, using the framework developed with the World Bank. The city issued SEK500 million in 2013 and a further SEK1.8 billion in the second quarter of 2014. These bonds would be used to finance the city's environmental programme, including spending on areas of renewable energy, public transport, water treatment and waste management, and also diversifies the city's financing through new investors.

Treasury policy limits refinancing risk by requiring that no more than 25% of long-term debt mature within the calendar year and no more than 35% of total external debt within 12 months. Gothenburg has entered into hedging agreements, mainly with Nordic banks. New counterparties must be rated A3 or higher; as of end 2013, 84% of counterparty risk was with counterparties rated at A3 or higher. The city maintains daily, weekly and monthly liquidity reporting and forecasting. Gothenburg also limits currency risk as all foreign currency borrowing is hedged.

Gothenburg's liquidity position is strong, although its cash position tends to be low. The city has several

mechanisms for raising liquidity. These include (1) SEK9 billion in liquidity lines with seven large Nordic financial institutions; and (2) the ability to borrow from Kommuninvest, a funding vehicle for the local government sector in Sweden. Cash and facilities are more than enough to cover maturing debt over the next 12 months.

#### **GROWING POPULATION IS LIKELY TO PUT PRESSURE ON DEBT LEVELS AS THE CITY INVESTS IN ORDER TO PROVIDE SERVICES**

Gothenburg's population has been growing steadily in recent years, primarily through immigration, growing by over 10% in the last decade to 533,300 at the end of 2013. This growth is creating significant pressures on sectors such as housing, education, health care and transportation. To address these pressures, we expect Gothenburg to incur additional borrowing to support services. Over the next four years, 2015-2018, the city projects needing to increase its capital expenditures above the SEK10 billion spent over 2011-14, with SEK3.6 billion in investments planned for 2015.

This development and infrastructure expansion is supported by planned projects already underway, including the River City development, which will increase housing supply, and the multi-year (to 2028) SEK34 billion West Sweden package, which would improve the transport infrastructure system in the region and is funded jointly by the Swedish government, two regions and several municipalities in Western Sweden (Gothenburg's share SEK1.3 billion). We expect that details on the overall level of capital spending over the medium term and how this will be financed will likely be determined after the fall elections.

#### **CONTINGENT LIABILITY OF THE CITY-CONTROLLED COMPANIES' DEBT BUT CHANGES IN CORPORATE STRUCTURE WILL RESULT IN GREATER CONTROL**

The city has on-lent the bulk of its direct debt (SEK22.8 billion at end 2013) to companies controlled by the city. In addition, indirect debt stood at SEK17.0 billion as at end December 2013, up from SEK15.9 billion in 2012. Of this, SEK15.3 billion is borrowed by Förvaltnings AB Framtiden, a financially sound property company wholly owned by the city. Net debt (debt net of on-lending to city companies and self-supporting entities) of the city stood at a considerably lower SEK3.2 billion at end December 2013. This is a small amount of debt compared with the city's revenues of SEK33.5 billion. Debt borrowed by city-controlled companies are, in our view, effectively contingent liabilities of the city.

In 2013, the city decided to restructure the company sector and transfer city-owned companies Förvaltnings AB Framtiden, Älvstranden Utveckling AB and Göteborg & Co Kommunintressent AB to Göteborgs Stadshus AB and Higab AB, respectively. This restructuring brings these companies closer to the city and resulted in an extraordinary receipt of SEK8.7 billion in 2013, though this was matched by an equivalent increase in the city's financial assets in the form of shares and thus no real change in the city's financial position. Going forward, financing for these companies will take place through the city with the city on-lending and charging market interest rates to these companies. Presently, Framtiden makes up the majority of the city's indirect debt. As a result of this move to bring financing in-house, the city's direct debt will increase and indirect debt will decrease as Framtiden's debt is assumed; the city's net debt, however, would not be affected by this change as we view Framtiden as self-supporting. As Treasury functions are consolidated, the city will centralise financial functions and improve risk control, giving the city greater control of these city-owned companies.

#### **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 to 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.

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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	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	5	[1]100	70%	3.8	20%	0.76
Economic volatility	1		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	1		50%	2	20%	0.40
Financial flexibility	3		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenues (%)	5	4.86	12.5%	2.5	30%	0.75
Interest payments / operating revenues (%)	5	4.42	12.5%			

Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	11.43	25%			
Short-term direct debt / total direct debt (%)	3	10.98	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						2.21(2)
<b>Systemic Risk Assessment</b>						Aaa
<b>Suggested BCA</b>						aa1

[1] Economic strength is a Moody's estimate as this ratio is not produced by relevant statistical offices

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