

# MOODY'S

## INVESTORS SERVICE

### Credit Opinion: Gothenburg, City of

Global Credit Research - 13 May 2015

Sweden

#### Ratings

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

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#### Key Indicators

##### Gothenburg, City of (Unconsolidated)

	2010	2011	2012	2013	2014
Net direct and indirect debt / operating revenue (%)	9.4%	8.5%	11.4%	10.5%	10.6%
Gross interest expenses / operating revenue (%)	2.7%	5.0%	4.6%	3.6%	2.9%
Gross operating balance / operating revenue (%)	6.9%	5.6%	4.0%	4.0%	3.9%
Cash financing surplus (requirement) / total revenue (%)	-3.7%	-3.9%	5.2%	22.0%	-1.5%
Intergovernmental revenues / total revenue (%)	5.6%	5.2%	5.1%	5.1%	5.5%

#### 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 and 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, with stable 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 is likely to put pressure on required investment and debt levels
- Eroded operating margins moving forward due to higher expenditures
- 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 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 could exert pressure on the credit. Additionally, a significant increase in the debt burden and/or city owned liabilities 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 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 faces 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. The gross operating balance (GOB) has consistently been positive, averaging 4.87% of operating revenues over the last five years. In 2014, the GOB was SEK1.34 billion, or 3.86% of operating revenues.

In 2014 operating revenues were SEK34.5 billion, an increase of 3.9% from 2013 largely due to increased tax revenues. The bulk of Gothenburg's revenues stems from local taxes, which accounted for 74% of total revenues in 2014. Intergovernmental transfers, in the form of tax equalisation grants make up 6% and the balance comes from fees and commissions, financial income from city-owned companies and other sources. The operating revenue breakdown has remained almost unchanged over the past five years.

In 2014 operating expenses were SEK33.2 billion, an increase of 4.1% from 2013. About half of operating expenses consist of personnel costs. The remainder includes: costs of goods and services (44%); interest expenses (3%); and transfers for financial assistance (4%).

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

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 closely monitors the municipal sector.

As is the case for most municipalities in Sweden, Gothenburg receives a grant under the Swedish equalisation system. In 2014, equalisation grants were SEK3.3 billion, similar to the year before. General grants were SEK1.9 billion in 2014, slightly higher than in 2013 but remaining relatively stable over the last five years. These government grants are credit positive as they provide a measure of stability against any volatility in the local economy.

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 8.8% in 2014 and has been declining for the last three years despite being marginally higher than the national average (8.0%).

Gothenburg is the second largest city in Sweden with a population of over 541,000 inhabitants, approximately 6% 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. We believe Gothenburg is in a strong position to assume more debt because of its current low level.

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

Net direct and indirect debt are calculated at 10.61% of operating revenues at year end 2014, this is marginally higher than the 9.6% recorded the year before. Gothenburg currently has low net debt levels because the city borrows on behalf of city-owned companies and Moody's perceives such company on-lending as fully self-supporting. The city owned companies are judged as self-supporting due to their strong track record of self-sufficiency and positive contributions to the city's revenues.

When including all the contingent liabilities, in the form of self-supporting debt on-lent to the city owned companies as well as guaranteed debt, total debt would reach 125% of operating revenues in 2014. We expect, however, that Gothenburg will assume more debt in the coming years in order to invest to provide services to a growing population. Higher debt levels are, however, unlikely to compromise Gothenburg's Aaa rating because its current net debt levels are currently low.

Gothenburg's funding comes primarily through its EUR6 billion MTN programme and SEK6 billion CP programme. It also has a USD500 million ECP. The utilisation of the existing programmes is comfortable away from their loan limits (33%). Additional loans include those from the European Investment Bank and Kommuninvest (Aaa), a funding vehicle for the local government sector in Sweden.

Treasury policy limits refinancing risk by requiring that no more than 25% of long-term debt maturing within any calendar year and no more than 35% of total external debt within 12 months. Moody's views that this policy fairly balances the refinancing risk to the relatively short dated debt issued by the city, with the average duration of their long term debt maturing at 3.3 years.

The city maintains daily, weekly and monthly liquidity reporting. Gothenburg's overall liquidity position is strong, although its cash position tends to be low as they attempt to avoid any cost of carry. The city does however have several mechanisms for raising liquidity if required. These include (1) SEK9 billion in liquidity lines with seven large Nordic financial institutions; and (2) the ability to borrow from Kommuninvest (Aaa). Cash and facilities are more than enough to cover maturing debt over the next 12 months under any stressed scenario.

New counterparty risk must be rated A3 or higher; as of end 2014, 92% of counterparty risk was with counterparties rated at A3 or higher. Gothenburg also limits currency risk as all foreign currency borrowing is hedged back to SEK.

#### GROWING POPULATION IS LIKELY TO PUT PRESSURE ON REQUIRED INVESTMENT AND DEBT LEVELS

The city has grown by over 10% in the last decade to 541,000 inhabitants at the end of 2014 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, we expect Gothenburg to incur additional borrowing to support these services. Over the next four years, 2015-2018, the city projects an increase in its investments to

reach SEK20 billion. This is more than twice the amount invested between 2011-2014. The majority of these future investments are expected to be financed via increased debt levels. We expect that details on the overall level of capital spend over the medium term might shift as this remains under political discussion. Moody's will continue to monitor the amount of investments debt issued and expect this to be managed appropriately moving forward.

#### **ERODED OPERATING MARGINS MOVING FORWARD DUE TO HIGHER EXPENDITURES**

The 2016-18 Budget has been released and the city expects to run a balanced budget over the coming years. As a result of the higher spending levels, Moody's anticipates to see the gap between revenue and expenditure growth rate widen. As operating expenditure growth rates outpace revenue growth rates, the positive GOB experienced over the past years is forecasted to be eroded. Moody's takes comfort in the requirements for a Balanced Budget, and that any resulting deficit must be corrected within three years.

#### **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 anticipated investments in the city owned companies between 2015-2020. The investment in the city owned companies will peak in 2020 with new investments in city-owned companies expected at SEK6.0bn. 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 SEK38.6 billion and would equal 112% of operating revenues in 2014. We anticipate this number to increase following the anticipated investments.

In 2014 the city has on-lent SEK24.7 billion or 90% of its direct debt to companies controlled by the city. In addition, the indirect debt which was issued independently by the companies was reported at SEK11.0 billion. Förvaltnings AB Framtiden, a property company, represents the lion share of this debt, as they have SEK8.2billion in outstanding equal to 74% of the city's indirect debt. We anticipate the amount of indirect debt to amortise over the next 5 years as city owned companies are no longer allowed to issue independent own named debt under the modified corporate governance guidelines.

The modified corporate governance guidelines applies to all city owned companies and aims to centralise all financing functions for both the City Authority and the City's companies. Since 2013, financing for these companies will take 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 SEK27.6 billion in 2014 from SEK22.8 billion in 2013 while indirect debt issued independently by the companies decreased to SEK11 billion in 2014 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 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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### 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 June 2014 entitled "Mapping Moody's National Scale Ratings to 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	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	5	100.00	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	3.94	12.5%	3	30%	0.90
Interest payments / operating revenues (%)	5	3.32	12.5%			
Liquidity	1		25%			

Net direct and indirect debt / operating revenues (%)	1	10.61	25%			
Short-term direct debt / total direct debt (%)	5	28.16	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>						2.36(2)
<b>Systemic Risk Assessment</b>						Aaa
<b>Suggested BCA</b>						aa1

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