MOODY'S
INVESTORS SERVICE

Credit Opinion: Ekurhuleni, Metropolitan Municipality of

Global Credit Research - 21 Dec 2015

South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating	A1.za
NSR Senior Unsecured	A1.za
NSR ST Issuer Rating	P-1.za

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Key Indicators

Ekurhuleni, Metropolitan Municipality of

	2010	2011	2012	2013	2014
Net direct and indirect debt/Operating revenue (%)	19.2	22.6	20.8	20.6	20.6
Interest Payments/Operating Revenue (%)	2.4	2.4	2.3	2.5	2.5
Gross Operating Balance/Operating Revenue (%)	0.2	2.5	6.6	8.5	9.5
Cash Financing Surplus (Requirement)/Total Revenue (%)	-8.4	-4.8	5.2	5.2	-1.8
Intergovernmental Transfer/Operating Revenue (%)	17.4	17.2	16.6	16.5	15.5
Real GDP (% change) [1]	3.2	4.0	2.9	3.2	-
GDP per capita as % of National Average	150.6	145.4	146.4	158.7	-

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

The A1.za/P-1.za national scale issuer and debt ratings of Ekurhuleni Metropolitan Municipality reflect its relatively large economic base, strong liquidity and traditionally conservative approach to financial management. However, the ratings also reflect the challenges associated with growing, albeit moderate, debt levels (including exposure to municipally owned entities' anticipated increasing debt) and the city's high expenditure requirements over the medium-term.

On 18 December 2015, Moody's Investors Service changed the outlook of Ekurhuleni Metropolitan Municipality to negative from stable and affirmed the A1.za /P-1.za national scale issuer ratings. This action was prompted by the deterioration of South Africa's credit profile as captured by Moody's outlook change to negative from stable of South Africa's Baa2 government bond rating on 15 December 2015.

National Peer Comparison

The City of Ekurhuleni is rated at the high end of the range of South African municipalities, whose ratings span from A1.za to Baa3.za. Ekurhuleni's relative position reflects debt and debt service levels that are lower than the median of rated metropolitan municipalities, its strong liquidity position and its conservative financial management.

Credit Strengths

- Good financial performance, which reflects strong revenue growth

- Historically strong liquidity position

- Conservative financial management

- A relatively large economy, with a strong industrial base

Credit Challenges

- High capital expenditure pressure for service delivery

- Gradually increasing debt levels, but still moderate

Rating Outlook

The outlook on Ekurhuleni Metropolitan Municipality is negative in line with the Government of South Africa's ratings (Baa2/Negative).

What Could Change the Rating - Up

An upgrade of Ekurhuleni's rating could result from an upgrade of the sovereign rating.

What Could Change the Rating - Down

A downgrade of the sovereign rating would likely lead to downward adjustments of Ekurhuleni's rating. The city's rating would also come under pressure in the event of fiscal slippage, a weakening of its financial position and/or a higher-than-anticipated increase in financial leverage. A further weakening of the South African government's credit profile, reflected in a downgrade of the sovereign rating could negatively affect Ekurhuleni's rating.

Recent Developments

The weakening of South Africa's credit profile, as captured by the outlook change of the South African' sovereign bond rating to negative from stable on 15 December 2015, prompted a similar change to the outlook of 10 regional and local governments and two government-related issuers, including that of Ekurhuleni Metropolitan Municipality. The deterioration in South Africa's sovereign creditworthiness indicates a weakening operating environment for sub-sovereign issuers. The centralised nature of South Africa's local public sector results in close operational and financial links between the national government, large cities and medium-sized municipalities, whose budgetary structure and relative size expose them to the country's macroeconomic performance and socio-economic conditions to varying degrees. Small municipalities are highly reliant on government transfers for operating and capital investments.

DETAILED RATING CONSIDERATIONS

Ekurhuleni's A1.za rating combines (1) the entity's baseline credit assessment (BCA) of baa2, and (2) a moderate likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

GOOD FINANCIAL PERFOMANCE, WHICH REFLECTS STRONG REVENUE GROWTH

Based on a total revenue of ZAR25.1 billion ($2.1 billion) for the fiscal year ending (FYE) June 2014, Ekurhuleni ranks third among the six metropolitan municipalities rated by Moody's in South Africa, after Cape Town (A1.za Negative) and Johannesburg (A2.za Negative). The city recorded a robust revenue growth of 16% on average during 2010-14. The strong budgetary performance was underpinned by a growing revenue base, which is largely driven by service charges, property rates charges as well as consistent growth in fiscal transfers from national government. Combined with continued fiscal discipline, these key revenue drivers contributed to an improvement in gross operating margins to 9.5% in FYE 2014 from 8.5% in FYE 2013.

Discretionary own-source revenues constitute 84%, indicating the city's relatively high revenue autonomy. On the expenditure side of operations, non-discretionary items, such as employee costs for its approximately 15,000 staff members and bulk purchases, represent a large and growing proportion (70%) of operating expenditure. Ekurhuleni's spending on repairs and maintenance constitutes 6% of operating expenditures, in line with that of other rated peers.

HISTORICALLY STRONG LIQUIDITY POSITION

Continued focus on revenue collections and tight control over expenditure dynamics have allowed Ekurhuleni to consolidate its strong liquidity position. The city's liquidity ratio (Current Assets/Current Liabilities - Net off 50% of Balance sheet Debtors) improved to 1.5x in FY 2014, up from 1.2x in FYE 2013.

Accompanied by the city's historical policy to keep expenditure within revenue-generating capacity levels, increased revenue collection (92%) has helped the city to record an improved cash & cash equivalent to ZAR6.1 billion in FY 2014, from ZAR4.4 billion in 2013, equivalent to 26% of total expenditure. Going forward, the city projects cash and cash equivalents to increase moderately notwithstanding the expected increase in cash contributions from its own sources in funding capital investments.

CONSERVATIVE FINANCIAL MANAGEMENT

Ekurhuleni has traditionally displayed conservative financial management and good budgetary planning. Whilst the municipal administration was able to focus on strengthening revenue collection and prudently continued to manage its spending dynamics, the city's intention to reduce infrastructure backlogs via annual capex increases in the medium-term will likely suppress financial performance and exert modest pressure on financial leverage.

A RELATIVELY LARGE ECONOMY, WITH A STRONG INDUSTRIAL BASE

Ekurhuleni displays a large and relatively dynamic economic base. The local economy is driven by manufacturing; however, contribution by wholesale and retail trade as well as finance and business services to the local economy is significant and provides some diversification.

The municipality has a population of about 3.2 million, accounting for 26% of Gauteng Province's total population and 6.2% of South Africa's and it contributes around 7% to national economic output. Transport networks are well developed and have contributed to notable industrial growth in the area over the years. The metropolitan municipality is home to the Oliver Tambo International Airport, the busiest airport in Africa. The Local Economic Development plan of the city identified a number of economic development projects, which will largely take place around the airport precinct.

Typical of large municipalities in South Africa, migration into the area is an inherent challenge, with growing informal settlements in the area putting significant expenditure pressure on provision services, including housing.

HIGH CAPITAL EXPENDITURE PRESSURE FOR SERVICE DELIVERY

On the capital side of the budget, the city increased spending on infrastructure projects to ZAR2.9 billion in 2014 from ZAR2.3 billion in 2013. Nonetheless, going forward, the city plans to ZAR14.6 billion on capital infrastructure from 2016-18 financial year The city will fund its capital investments largely from capital grants from the national government (55%), new borrowings (32%) and from own funds (13%).

GRADUALLY INCREASING DEBT LEVELS, BUT STILL MODERATE

Ekurhuleni's net direct debt amounted to ZAR4.9 billion as of 30 June 2014, which is equivalent to a moderate 21% of operating revenue and a slight decrease from 23% in FY 2011. Although Ekurhuleni's debt stock is moderately increasing year on year, its debt ratio remains range bound, thanks to constant revenue growth.

Ekurhuleni's debt stock consists of 53% bonds and 47% amortising bank loans, with an average debt maturity of six years. We expect that Ekurhuleni's debt burden will remain moderate in the medium-term, despite the acceleration in capital expenditure and the consequent increase in borrowing requirements. Interest expenses amount to approximately ZAR584 million, or 2.5% of operating revenue, for FYE 2014. They will likely remain moderate and grow in line with financial leverage in the medium-term.

The city's commitment to focusing on infrastructure investments will continue to require debt financing. The city's debt levels will increase moderately in the medium-term as a result of (1) ongoing bond issuances under the domestic medium-term note programme for financing capital expenditure and (2) its exposure to the ZAR550 million debt guarantee available for drawdown by East Rand Water Care Company. Nonetheless, growing revenue will mitigate the fiscal pressure stemming from rising debt levels.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government reflects our assessment of the national government's policy stance, at the jurisdictional level, on promoting greater accountability and financial sustainability for South African municipalities. The reputation risk for the central government is modest given the large predominance of bank loans instead of bonds. Although the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bail-out actions to avoid defaults on debt obligations. However, the government has some interest in addressing major financial problems that could be experienced by the metropolitan municipalities given their relative importance countrywide.

Output of the Baseline Credit Assessment Scorecard

In the case of Ekurhuleni, the BCA matrix generates an estimated BCA of baa3, close to the BCA of baa2 assigned by the rating committee.

The matrix-generated BCA of baa2 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 Baa2, as reflected in the sovereign bond rating (Baa2 negative).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated BCAs 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 higher ratings are generally likely among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual BCAs, and the scorecard is not 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

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 low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Ekurhuleni, Metropolitan Municipality of

Baseline Credit Assessment Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals						
Economic strength	1	143.20	70%	1	20%	0.20
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	5	20%	1.00
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	9.11	12.5%	1.5	30%	0.45
Interest payments / operating revenues (%)	3	2.47	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	20.60	25%			
Short-term direct debt / total direct debt (%)	1	10.00	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						1.95(2)
Systemic Risk Assessment						Baa2
Suggested BCA						baa3

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