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Credit Opinion: Ekurhuleni, Metropolitan Municipality of

Global Credit Research - 02 Jul 2012

South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Aa2.za
NSR ST Issuer Rating -Dom Curr	P-1.za
NSR Senior Unsecured -Dom Curr	Aa2.za

Contacts

Analyst	Phone
Kenneth Morare/Johannesburg	27.11.217.5470
Francesco Soldi/Milan	39.02.9148.1100
David Rubinoff/London	44.20.7772.5454

Key Indicators

Ekurhuleni, Metropolitan Municipality of

	2007	2008	2009	2010	2011
Net direct and indirect debt/Operating revenue (%)	8.8	7.8	15.9	19.2	23.1
Interest Payments/Operating Revenue (%)	1.8	1.8	1.8	2.4	2.4
Gross Operating Balance/Operating Revenue (%)	11.1	1.7	-6.6	0.2	5.9
Cash Financing Surplus (Requirement)/Total Revenue (%)	4.0	-5.6	-22.5	-8.4	-3.9
Intergovernmental Transfer/Operating Revenue (%)	19.4	17.8	18.0	17.4	16.8
Real GDP (% change) [1]	6.0	4.0	-1.7	3.2	3.1
GDP per capita as % of National Average	168.0	156.8	158.7	150.6	-

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

Ekurhuleni Metropolitan Municipality's Aa2.za/Prime-1.za national scale issuer and debt ratings are underpinned by its relatively large economic base, its moderate - albeit gradually growing debt levels (including municipally owned entities), and its traditionally conservative approach to financial management. However, the ratings also consider the fiscal challenges associated with relatively low, but gradually improving, revenue collection rates and the city's high expenditure requirements, and their potential impact on the city's financial performance and liquidity position in the medium term.

National Peer Comparison

Ekurhuleni is rated at the high end of the six metropolitan municipalities rated by Moody's in South Africa, whose ratings span from Aa2.za to A1.za. Ekurhuleni's relative position reflects debt and debt service levels that are lower than the median of the metropolitan municipalities, improving liquidity and conservative financial management.

Credit Strengths

Credit strengths for Ekurhuleni include:

- Strengthening financial performance

- Moderate debt levels, albeit gradually growing

- Conservative financial management

- A relatively large economy, with a strong industrial base

Credit Challenges

Credit challenges for Ekurhuleni include:

- Weak revenue collection rates , albeit gradually improving

- High capital expenditure pressure for service delivery

Rating Outlook

The negative rating outlook mirrors the outlook on South Africa's government bond rating.

What Could Change the Rating - Up

An upgrade is regarded as unlikely given the negative rating outlook. A stabilisation of Ekurhuleni's rating outlook would require a stabilisation of the sovereign rating outlook.

What Could Change the Rating - Down

A downgrade of South Africa's sovereign rating would likely lead to a downgrade of Ekurhuleni's rating. The city's ratings would also come under pressure in the event of fiscal slippage, leading to a weakening of its financial position and/or increase in debt levels.

DETAILED RATING CONSIDERATIONS

The rating assigned to the City of Ekurhuleni reflects the application of Moody's Joint Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the municipality and then considers the likelihood of support coming from the national government in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

Ekurhuleni's BCA of 7 (on a scale of 1-21, where 1 represents the lowest credit risk) reflects the following factors:

Financial Position and Performance

Based on total revenue of ZAR17.3 billion (US$2 billion) for the fiscal year ending (FYE) June 2011, Ekurhuleni ranks third among the six metropolitan municipalities rated by Moody's in South Africa. Following lower revenue growth recorded in 2008-09 due to the economic downturn, total revenue rebounded (+23%) in 2010-11. This sound revenue growth, coupled with conservative expenditure policies have enabled the city to significantly improve its financial position. Gross operating margins strengthened to 5.9% in FYE2011, from 0.2% in FYE2010, allowing the city to absorb growing interest costs associated with the growing debt exposure.

Discretionary revenues to operating revenues constitutes 90% and indicating the city's relatively high revenue autonomy. Similar to other metropolitan municipalities, Ekurhuleni has broad operating and capital-related expenditure responsibilities, although most of these expenditures are rigid and compress operating margins. Non-discretionary expenditure, such as employee costs for its approximately 15,000 staff and bulk purchases represent a large and growing proportion (60%) of total expenditure, with the city committed to improve water and electricity distribution losses over the medium term. Repairs and maintenance expenditure remain stable at a moderate 7% of total expenses.

Continued fiscal discipline accompanied by slight improvements in revenue collection have contributed significantly towards strong cash flows, resulting in improved liquidity of 0.9x in FYE2011, from a five-year low 0.6x in FYE2010. The city expects the cash reserves to improve in the medium-term, supported by the company's historical policy strategy to keep expenditure within revenue-generating capacity levels.

On the capital side of the budget, the city estimates ZAR2.2 billion capital expenditure for FYE2012, slightly above the two preceding years. Going forward, the city projects a total of ZAR8.1 billion in capital expenditure in 2013 - 2015. The funding mix for this capex program comprises capital grants (59%), new borrowings (29%) and own-funds (12%).

Debt Profile

Ekurhuleni's net direct debt is estimated to amount to ZAR4.6 billion as at 30 June 2012, equivalent to a moderate 21% of forecast operating revenue, a slight decrease from 23% in FY2011. This debt stock comprises both direct municipal debt of ZAR4.5 billion and the first drawdown of ZAR50 million in guaranteed debt to be incurred by its waste water treatment company (ERWAT).

Ekurhuleni's direct debt stock comprises mainly bonds (approximately 54%) and amortising bank loans (46%), with an average debt maturity of seven years. Sinking fund deposits and/or long-term cash investments established for the redemption of its long-term loans are estimated at ZAR434 million for FYE2012 and are expected to continue increasing in order to accommodate the redemption of the bullet bonds issued by the city in the past three years, of which the first (EMM01) is due in the next eight years. Interest expenses will reach approximately ZAR461 million or 2.4% of operating revenue for FYE2012 and this ratio is expected to remain flat 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 near term, due to bond issuances under the program as well as the outstanding ZAR500 million debt guarantee available for drawdown by ERWAT. Nonetheless, Moody's view the city's prospective indebtedness as manageable against increased budget volumes.

Governance and Management Factors

Ekurhuleni has traditionally displayed conservative financial management and budgetary planning. The city consistently provides annual financial statements, including balance sheets, income statements and cash flow statements, which are always independently audited by the Auditor General and has received unqualified opinion for three years in succession to FYE2011.

Among the major future challenges for the municipal administration, we note that the city will need to build on recent improvements in revenue collection and prudently manage its financial leverage, including indirect debt exposure from its municipal entities.

Economic Fundamentals

Ekurhuleni displays a large and relatively dynamic economic base. The local economy is driven by manufacturing in the secondary sector, with a focus towards the production of structural steel and fabricated metal products. Notwithstanding manufacturing, contribution by wholesale & retail trade as well as finance & business services to the local economy is significant and provides further diversification.

The municipality has a population of 2.8 million, accounting for 28% of the Gauteng province's and 5.6% of South Africa's total population. Despite its location within Gauteng, which is the leading economic province of the country, the local economy has grown at a slightly slower rate than the national economy as a whole over the past 10 years, and its contribution to national economic output is estimated at around 7%. The city's economy was significantly impacted by the 2009 economic recession, with a local GDP slump of just above 3% recorded in that year mainly due to its export-linked manufacturing base. 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. Ekurhuleni also has the largest industrial concentration in South Africa and is often referred to as the "workshop of Africa."

Typical of large municipalities in South Africa, migration into the area is a key challenge. In 2009, it was estimated that Ekurhuleni had more that 100 informal settlements in the area, the largest of all metropolitan municipalities in the country, which exerts significant expenditure pressure for service provisions and on housing.

Operating Environment

The operating environment in which Ekurhuleni operates is characterised by moderate-to-low GDP per capita, relatively low GDP volatility and a moderate ranking on the World Bank's Government Effectiveness Index. These characteristics suggest low systemic risk. The sovereign rating is currently A3, with negative outlook.

South Africa's economy is currently recovering from the mild recession experienced in 2009, having posted real GDP growth of 2.8% in 2010, which is well below pre-crisis levels. The recently published Medium-Term Budget Policy Statement (MTBPS) revised GDP growth forecasts downwards to 3.1%-3.5% in 2011 and 2012. This is expected to have an impact on the country's ability to deal with socio-economic challenges. Notwithstanding the country's political transformation and socio-economic progress, South Africa has a multitude of challenges, including high levels of poverty, soaring unemployment and under-employment, wide income disparities and poor general education attainment. If inadequately addressed, these challenges could threaten the long-term economic and political stability of the country.

Institutional Framework

The institutional framework, which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, features moderate financial predictability and stability. The municipal system in South Africa comprises eight metropolitan municipalities (category A), 226 local municipalities (category B) and 47 district municipalities (category C). The administration system and associated policies are generally consistent and oriented towards enhancing accountability at the local levels; municipal oversight regarding budget approval and monitoring is performed by provincial governments, assisted by the National Treasury.

Spending responsibilities and revenue structures of South African municipalities are difficult to alter due to a consolidated legal framework. The high degree of revenue autonomy enjoyed by metros and large local municipalities - with transfers from the national government accounting for 5-20% of total revenue - compensates for the rigidity of their expenditure profile as a result of their statutory responsibilities (which are chiefly related to the delivery of basic services and municipal infrastructure). Conversely, district and small to medium-sized municipalities - whose primary role is to facilitate, fund and execute infrastructure development in the local municipalities within their jurisdiction - demonstrate moderate-to-high fiscal dependence on government grants. Municipal budgets are sensitive to economic cycles due to the nature of their own revenue sources, which include primarily property taxes and service charges for electricity, water, refuse and sewage. Municipalities are responsible for the collection of local taxes and charges and enjoy the discretion to set tax rates and tariffs. This allows for a moderate degree of revenue flexibility, particularly for metros and large municipalities.

The combination of fiscal transfers and own-source revenues at most metros and local municipalities has proved insufficient to provide the comprehensive range of services required. However, despite these pressures, municipal debt levels have generally remained low to moderate.

Extraordinary Support Considerations

Moody's assigns a moderate likelihood of extraordinary support from the South African government, reflecting, at the jurisdictional level, Moody's assessment of the national government's policy stance of promoting greater accountability and financial sustainability for South African municipalities. Reputation risk for the central government is deemed modest, mainly in view of 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, Moody's recognises some interest of the government in addressing major financial problems that could be experienced by the metropolitan municipalities, in view of their relative importance countrywide.

Moody's also assigns a moderate level of default dependence between Ekurhuleni and the Republic of South Africa, reflecting a low reliance on national government transfers, its own sources of revenue distinct from those of the central government and the local economic base integrated with the national economy.

Output of the Baseline Credit Assessment Scorecard

In the case of Ekurhuleni, the BCA scorecard (presented below) generates an estimated BCA of 9, compared to the

BCA of 7 assigned by the rating committee. The two notch differential between the assigned BCA and the reference point generated by the scorecard reflects a number of factors not fully captured in the scorecard, including primarily the prudent financial management approach and budgetary planning, which support our expectations that the city will be able to preserve consistent fiscal discipline in the medium term.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard 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 the scorecard cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

Moody's National Scale 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 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 ratings, please refer to Moody's Rating Methodology published in March 2011 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.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

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%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Ekurhuleni, Metropolitan Municipality of

Baseline Credit Assessment Scorecard - 2010	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
Factor 1: Operating Environment						
National GDP per capita (PPP basis, $US)	10 416	15	50.0%	10.50	60.0%	6.30
National GDP Volatility (%)	2.4	3	25.0%			
National Govt Effectiveness Index (World Bank)	0.34	9	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.00	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	7.5	7.5	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	15	15	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	2.1	3	25.0%	9.75	7.5%	0.73
Cash Financing Surplus(Req)/Total Revenue (%)	-12.0	15	25.0%			
Gross Operating Balance/Operating Revenue (%)	-1.5	12	25.0%			
Net Working Capital/Total Expenditures	1.4	9	25.0%			
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	19.2	1	50.0%	5.00	7.5%	0.38
Short-Term Direct Debt/Direct Debt (%)	15.1	3	25.0%			
Net Debt/Operating Revenue Trend	45.2	15	25.0%			
Factor 5: Governance & Management						
Fiscal Management	1	1	40.0%	2.95	7.5%	0.22
Investment & Debt Management	7.5	7.5	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	7.5	7.5	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated ($US)	16 034	9	100.0%	9.00	7.5%	0.68
Estimated BCA						**9**

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