

CREDIT OPINION

11 November 2019

Update

 Rate this Research

RATINGS

Ekurhuleni, City of

Domicile	South Africa
Long Term Rating	Baa3
Type	LT Issuer Rating - Dom Curr
Outlook	Negative

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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City of Ekurhuleni (South Africa)

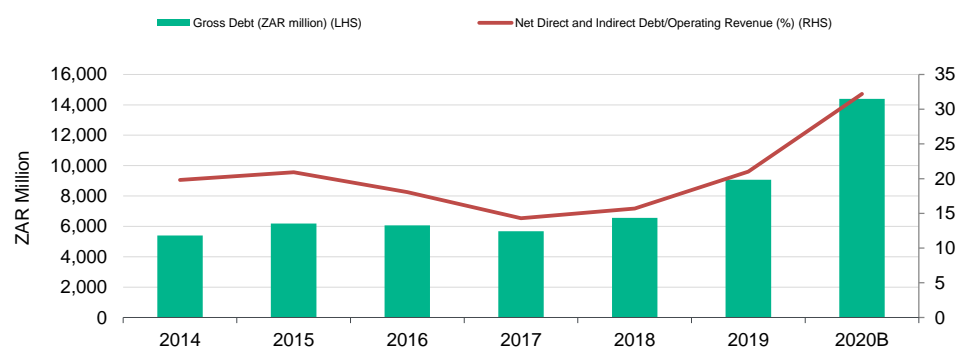
Update following change in outlook to negative from stable

Summary

The credit profile of the [City of Ekurhuleni](#) (Baa3/Aa1.za) reflects its deteriorating financial performance and liquidity profile, and rising debt levels because of an increase in planned capital spending over the next three years. The credit profile also reflects the city's large and diverse economic base, and the weakening of its support provider's, the [Government of South Africa](#), (Baa3 negative) credit profile.

Exhibit 1

Ekurhuleni's debt levels to increase in 2020 but its debt ratio will remain in line with other rated peers



Figures for 2019 are actual unaudited.

B: Budget.

Sources: City of Ekurhuleni and Moody's Investors Service

Credit strengths

- » Large economy with a strong industrial base
- » Good governance, management and internal controls

Credit challenges

- » Weakening financial performances, reflecting an increase in expenditure pressures
- » Weakening liquidity profile
- » High capital spending pressure for service delivery
- » Rising debt levels, although these will remain in line with those of its South African peers that we rate

Rating outlook

The negative outlook reflects the weakening of the sovereign credit profile. It also reflects our expectation that the City of Ekurhuleni's liquidity will remain constrained as a result of increased capital spending over the next three years and weaker operating performance.

Factors that could lead to an upgrade

Although an upgrade is currently unlikely in view of the negative rating outlook, we would consider stabilising the city's outlook in the event the South Africa government rating outlook is stabilised.

Factors that could lead to a downgrade

We would consider downgrading Ekurhuleni's ratings if its operating performance and its liquidity deteriorate beyond our expectations. We would also downgrade its global scale rating if South Africa's government bond rating is downgraded.

Key indicators

Exhibit 2

City of Ekurhuleni

Year ended 30 June 2019

Ekurhuleni, Metropolitan Municipality of						
	2014	2015	2016	2017	2018	2019 [1]
Net direct and indirect debt/Operating revenue (%)	19.8	20.9	18.0	14.3	15.7	21.0
Interest Payments/Operating Revenue (%)	2.5	2.3	3.3	3.3	3.1	2.8
Gross Operating Balance/Operating Revenue (%)	9.5	8.3	6.1	4.3	3.9	2.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	4.9	3.9	1.9	-6.3	-9.4	-7.3
Intergovernmental Transfer/Operating Revenue (%)	15.5	15.3	16.2	17.2	16.7	16.6
Real GDP (% change) [1]	2.4	1.2	1.2	1.1	-	-
GDP per capita as % of National Average	143.6	142.1	142.3	135.6	-	-
[1] 2019 AFS actual unaudited						
[2] GDP at provincial level.						

Figures for 2019 are actual unaudited.

Sources: City of Ekurhuleni and Moody's Investors Service

Detailed credit considerations

On 7 November 2019, [we affirmed the City of Ekurhuleni's Baa3 rating and changed the outlook to negative from stable](#). The change in outlook to negative from stable on the City of Ekurhuleni mirrors the weakening of the sovereign credit profile. We also downgraded the long-term national scale rating to Aa1.za from Aaa.za. The decision for downgrading the national scale rating reflects the weakening in its operating performance and liquidity relative to other rated peers in the country.

The credit profile of the City of Ekurhuleni, as expressed in its Baa3 negative rating, combines (1) a Baseline Credit Assessment (BCA) of baa3, and (2) a moderate likelihood of extraordinary support from the national government should the city face acute liquidity stress.

Baseline Credit Assessment

Large economy, with a strong industrial base

Ekurhuleni's economic base is large and relatively diverse, and is driven by manufacturing. Wholesale and retail trade, and finance and business services are also significant contributors, providing some diversification. Ekurhuleni's population of around 3.5 million accounts for 25% of the population of Gauteng Province and 5.8% of the population of South Africa. The city accounts for around 8.1% of national economic output.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Ekurhuleni's well-developed transport network has contributed to notable industrial growth. The Oliver Tambo International Airport is the busiest in Africa, and the city is building on this economic advantage. A local economic development plan has identified a number of projects, primarily around the airport precinct, to promote economic growth and job creation.

Typical of large municipalities in South Africa, migration to the area presents a challenge. Growing informal settlements are putting significant pressure on spending because of the need to provide basic services, including housing.

Good governance, management and internal controls

Ekurhuleni continues to display good budgetary planning, and we expect it to improve over the next three years. Following the weakening of its liquidity position in the past three years, Ekurhuleni's administration is committed to reduce its capital spending and borrowing in its 2019/20 adjustment budget to mitigate liquidity pressure. The city has also shown good internal controls and reporting over the years, with the city receiving an unqualified audit opinion for its 2017-18 financial statements.

Weakening financial performance, reflecting an increase in expenditure pressures

With total revenue of ZAR36.2 billion (\$2.8 billion) for the fiscal year ended 30 June 2019 (unaudited fiscal 2019), Ekurhuleni ranks third in terms of total revenue among the six South African metropolitan municipalities we rate after the [City of Cape Town](#) (Baa3 negative) and the [City of Johannesburg](#) (Baa3 negative).

The city's operating performance has, however, started deteriorating. Its gross operating balance decreased to 2.3% in fiscal 2019 from 6.1% in fiscal 2016. The decline is mainly a result of continuously increasing operating expenditure, at an average growth rate of 8% relative to average operating revenue growth of 7% over the past three years. The growth in operating expenditure is mainly driven by an increase in employee cost, which increased by 17% in fiscal 2018 and a further 13% in fiscal 2019, and provision for bad debt, with an average growth rate of 37% over the past three years, as well as the decline in non-core revenues sources.

Discretionary own-source revenue remains the major contributor to the city's operating revenue, at 83% in fiscal 2019. Non-discretionary items, such as costs related to Ekurhuleni's around 15,000 employees and bulk purchases related to water and electricity, are the main contributors to operating expenditure. They accounted for a high 66% in fiscal 2019 and are expected to account for 70% in both fiscal 2020 and fiscal 2021, providing the city with very limited spending flexibility.

Weakening liquidity profile

Ekurhuleni's liquidity has deteriorated over the past three fiscal years (2017-19). According to the 2019 unaudited results, Ekurhuleni recorded a cash and cash equivalents balance of ZAR3.7 billion, down from ZAR4.2 billion in fiscal 2018, following a decline from ZAR6.1 billion in fiscal 2017. The decline in cash is mainly because of a decrease in cash from operating activities and a substantial increase in capital spending, part of which was financed by own funds.

Net cash from operations declined by 36% in fiscal 2017, a further 1% in fiscal 2018 and then increased by only 6% in fiscal 2019, which does not counter the previous significant decreases. On the other hand, capital spending increased by 14%, 17% and 7% in fiscal 2017, fiscal 2018 and fiscal 2019, respectively. However, cash declined over this period, despite the metro raising a new loan of ZAR1.3 billion in fiscal 2018 and a further ZAR3 billion in fiscal 2019. Strain on Ekurhuleni's liquidity is also indicated by a substantial decline in its cash interest cover to 4x in fiscal 2019 from 7x in fiscal 2017. We expect liquidity to remain strained despite a possible cut in the budgeted capital spending.

High capital spending pressure for service delivery

An increase in Ekurhuleni's population because of urbanisation and the city's mandate to provide basic services mean that local authorities remain under pressure to increase capital spending to meet demand for services and improve local residents' quality of life. The city has budgeted to increase capital spending to ZAR22 billion over the next three years, fiscal 2020-22, financed by borrowing (48%), capital grants (38%) and own funds (14%). However, the city has the liberty to reduce these budgeted figures. As a result, the city's gross debt will increase to ZAR14 billion in fiscal 2020 from ZAR9 billion in fiscal 2019.

Rising debt levels, although these will remain in line with those of its South African peers that we rate

In Ekurhuleni's medium-term budget, net direct and indirect debt increases to 32.2% of operating revenue in fiscal 2020 from 21% in fiscal 2019, but its overall indebtedness will remain in line with that of its South African peers that we rate. The city's plans to

spend ZAR7.4 billion on capital infrastructure in fiscal 2020 compared with ZAR6.2 billion in fiscal 2019 are behind the projected debt increase, however the city is likely to reduce its capital expenditure plan during its adjustment budget in January 2020.

Ekurhuleni's debt stock consists of amortising bonds (31%), bullet bonds (28%), bullet bank loans (24%) and amortising bank loans (17%). Ekurhuleni will be redeeming two of its bullet bonds bond 01 and bond 02) in fiscal 2021, amounting to ZAR1.6 billion; the redemption will be covered by the city's sinking fund investments. Interest expenses for fiscal 2019 amounted to around ZAR947 million, or 2.8% of operating revenue, and are expected to increase to ZAR1.1 billion in fiscal 2020 and ZAR1.4 billion in 2021. Interest expense/operating revenue is expected to increase to an average 3.4% over the next three years as debt continues to increase.

Ekurhuleni's commitment to focus on infrastructure investments will continue to require debt financing. As a result, debt consisting of amortising and bullet bank loans, will increase over the next three years.

Extraordinary support considerations

We believe the City of Ekurhuleni has a moderate likelihood of receiving extraordinary support from the Government of South Africa. This reflects our assessment of the national government's policy stance, at the jurisdictional level, of promoting greater accountability and financial sustainability for South African municipalities. The reputational risk for the national government is modest, given the predominance of bank loans as opposed to bonds.

Although the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bailout actions to avoid defaults on debt obligations. However, the government has an interest in addressing major financial problems that metropolitan municipalities could experience, given their relative importance across the country.

ESG considerations

How environmental, social and governance risks inform our credit analysis of the City of Ekurhuleni

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of City of Ekurhuleni, the materiality of ESG factors to its credit profile is as follows:

Environmental considerations are material to the City of Ekurhuleni's credit profile. In line with the rest of South Africa, its main exposures relate to water shortages. South Africa is considered as a water-scarce country; drought is the most frequent environmental constrain that directly affects the city's revenue. This is managed through partnerships between the central government's department of water and the city; however, some of the financial burden for implementing and maintaining diverse water sources will be borne by the city. All large metropolitan municipalities including City of Ekurhuleni have increased their focus on water-related infrastructure investment in their 2020-22 capital budgets.

Social considerations are material to the city's credit profile. Although the economy is large and relatively richer than the national average, the city faces growing demographic-related spending pressures. Demographic pressures are likely to continue to grow as a result of high levels of urbanisation and population growth, and it will become increasingly difficult for the city to meet the required capital infrastructure spending. City of Ekurhuleni also faces a high unemployment rate, which directly affects the ability of its residents to pay for services, and increases the number of households that are entirely dependent on the city for basic services. In addition to this, South Africa has one of the highest social inequality rates in the world and this also filters through to the local governments in the country, creating risks of social unrest.

Governance considerations are material to the City of Ekurhuleni's credit profile. The city's strong administration has managed to implement prudent financial practices over the years, which led to the city attaining an unqualified audit opinion in fiscal 2018. Like all local governments in South Africa, City of Ekurhuleni's financial undertakings are guided by the Municipal Finance Management Act, and by the national government through the treasury, which plays an oversight role. Data transparency is very high, with all financial statements, along with medium-term budgets, published publicly on the city's and national treasury's website.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology, [General Principles for Assessing ESG Risks](#), published in January 2019.

Rating methodology and scorecard factors

The City of Ekurhuleni's assigned BCA of baa3 is close to the BCA of ba1 generated by the scorecard. The matrix-generated BCA of ba1 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 Baa3, as reflected by the sovereign bond rating for South Africa. For details on our rating approach, please refer to our [Regional and Local Governments](#) rating methodology, published on 16 January 2018.

Exhibit 3

Rating Factors						
Ekurhuleni, City of						
Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	135.60	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 (%)	5	3.04	12.5%	1.75	30%	0.53
Interest payments / operating revenues (%)	3	2.96	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	21.00	25%			
Short-term direct debt / total direct debt (%)	1	5.60	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						2.03(2)
Systemic Risk Assessment						Baa3
Suggested BCA						ba1

Financials for 2019 are unaudited.

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
EKURHULENI, CITY OF	
Outlook	Negative
Issuer Rating -Dom Curr	Baa3
NSR Issuer Rating	Aa1.za
Senior Unsecured -Dom Curr	Baa3
NSR Senior Unsecured	Aa1.za
ST Issuer Rating -Dom Curr	P-3
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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