

CREDIT OPINION

20 March 2020

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)

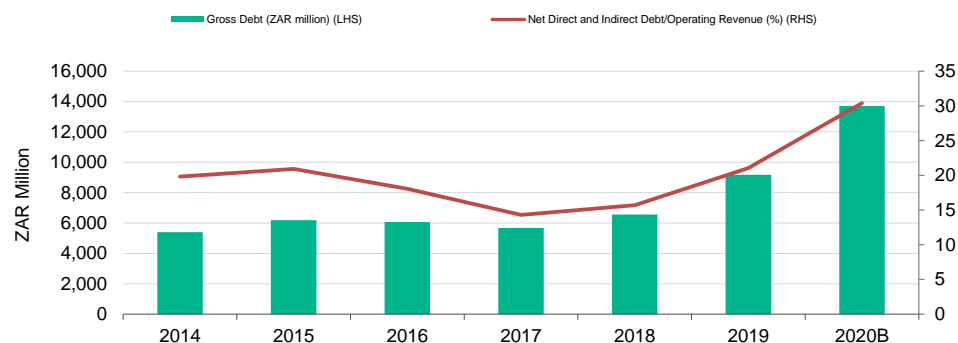
Update to credit analysis

Summary

The credit profile of the [City of Ekurhuleni](#) (Baa3 negative) reflects its weak financial performance and liquidity. However, it is likely to improve in the fiscal year ending 30 June 2020 (fiscal 2020). The credit profile also reflects (1) the city's rising debt levels because of an increase in planned capital spending over the next three years; (2) the city's large and diverse economic base; and (3) the weakening of the credit profile its support provider, the [Government of South Africa](#) (Baa3 negative).

Exhibit 1

The City of Ekurhuleni's debt levels are set to increase in fiscal 2020, but its debt ratio will remain in line with those of its peers we rate



B: Budget.

Fiscal year ending 30 June.

Sources: The 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 performance, which reflects an increase in spending pressures
- » Weakening liquidity
- » Pressure to increase capital spending for service delivery
- » Rising debt, although it will remain in line with that of its South African peers we rate

Rating outlook

The negative outlook 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. It also reflects the weakening of the sovereign's credit profile.

Factors that could lead to an upgrade

Although an upgrade is currently unlikely in view of the negative rating outlook, we would consider changing the city's outlook to stable in the event that there is a significant improvement in the city's liquidity and operating performance. We would also consider changing the rating outlook to stable if the South African government's rating outlook is changed to stable.

Factors that could lead to a downgrade

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

Key indicators

Exhibit 2

Ekurhuleni, City of					
	2015	2016	2017	2018	2019
Net direct and indirect debt/Operating revenue (%)	20.9	18.0	14.3	15.7	21.0
Interest Payments/Operating Revenue (%)	2.3	3.3	3.3	3.1	2.7
Gross Operating Balance/Operating Revenue (%)	8.3	6.1	4.3	3.9	-1.1
Cash Financing Surplus (Requirement)/Total Revenue (%)	3.9	1.9	-6.3	-9.4	-7.5
Intergovernmental Transfer/Operating Revenue (%)	15.3	16.2	17.2	16.7	16.4
Real GDP (% change) [1]	1.2	1.2	1.1	--	--
GDP per capita as % of National Average	142.1	142.3	135.6	--	--
[1] GDP at provincial level.					

Fiscal year ending 30 June.

Source: Moody's Investors Service and City of Ekurhuleni

Detailed credit considerations

The credit profile of the City of Ekurhuleni, as expressed by 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 if the city faces acute liquidity stress.

Baseline Credit Assessment

Large economy, with a strong industrial base

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

The City of Ekurhuleni's well-developed transport network has contributed to significantly to industrial growth. The Oliver Tambo International Airport is the busiest airport 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.

Migration to the area is a challenge, which is typical of large municipalities in South Africa. Growing informal settlements are exerting a significant strain on spending because of the need to provide basic services, including housing.

Good governance, management and internal controls

The City of Ekurhuleni continues to display good budgetary planning, and we expect it to improve over the next three years. Following the weakening of its liquidity over the past three years, the City of Ekurhuleni's administration is committed to reducing its capital spending

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and borrowing in its 2019-20 adjustment budget to mitigate the strain on its liquidity. The city has also shown good internal controls and reporting over the years, with the city receiving an unqualified audit opinion for its fiscal 2019 financial statements.

Weak financial performance, reflecting an increase in spending pressure

With total revenue of ZAR36.7 billion (\$2.6 billion) for fiscal 2019, the City of 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, further deteriorated in fiscal 2019. Its gross operating balance as a percentage of operating revenue declined to -1.1% in fiscal 2019 from a surplus of 3.9% in fiscal 2018. The growth in operating spending was mainly driven by (1) an increase in employee costs, which increased by 17% in fiscal 2018 and a further 13% in fiscal 2019; (2) provision for bad debts, with an average growth rate of 73% over the past three years; and (3) a decline in some noncore revenue sources. In 2020, we expect the city's operating balance to gradually improve, supported by a decline in operating expenditure. However we also note that the city's financial performance over the next three years will be constrained by the macroeconomic conditions in the country which may result in lower than expected collection rates leading to higher provisions for debt impairment.

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 the City of Ekurhuleni's around 15,000 employees and bulk purchases related to water and electricity, are the main contributors to operating spending. 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.

Weak liquidity, which is projected to improve

The City of Ekurhuleni's liquidity has deteriorated over the past three fiscal years (2017-19). According to the fiscal 2019 results, the City of Ekurhuleni recorded a cash and cash equivalents balance of ZAR3.5 billion, down from ZAR4.2 billion in fiscal 2018 and ZAR6.1 billion in fiscal 2017. The decline in cash was mainly because of a decrease in cash from operating activities and a substantial increase in capital spending, part of which was financed by its own funds. However, in fiscal 2020, the city expects to post an improved cash balance of ZAR4.9 billion.

We expect the city's liquidity to gradually improve in the next three years following the administration's decision to reduce capital spending in order to reduce the use of own funds in funding part of the capital expenditure which has weakened its liquidity over the past three years. The improvement in liquidity will also be mainly determined by whether the city manages to achieve the estimated debtors collection rates under the current macro economic conditions.

High capital spending pressure for service delivery

Infrastructure backlog and population growth, driven by urbanisation as well as the city's mandate to provide basic services, mean that local authorities remain under pressure to increase capital spending to meet the demand for services and improve local residents' quality of life. The city has budgeted to increase capital spending to ZAR20 billion over the next three fiscal years (2020-22), financed by borrowing (48%), capital grants (38%) and its own funds (14%).

However, the city has reduced its capital budget figures following its weakening operating performance and liquidity. As a result, the city's gross debt will increase to ZAR12.7 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 the City of Ekurhuleni's adjustment budget, net direct and indirect debt increases to 30% 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. According to the 2020 adjustment budget, the city reduced its capital spending to ZAR6.6 billion from the original budget of ZAR7.3 billion. The revised growth in capital spending represents only a 6% growth from the ZAR6.2 billion reported in fiscal 2019. We expect the city to follow a conservative approach towards borrowing, despite the lingering infrastructure backlog, the city's management have reduced borrowing to only ZAR2.5 billion per annum from the earlier projections of borrowing ZAR3.5 billion per annum over the next three years.

The City of Ekurhuleni's debt stock consists of amortising bonds (31%), bullet bonds (28%), bullet bank loans (24%) and amortising bank loans (17%). The City of 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. The redemption of the two bonds will mitigate the city's

increasing debt levels in the next three years. Interest expenses for fiscal 2019 amounted to around ZAR947 million, or 2.8% of operating revenue, and are expected to gradually increase in the next three years, in line with the city's revised borrowing plan. Interest expense/operating revenue is likely to increase to an average 3% over the next three years as debt continues to increase.

Extraordinary support considerations

The City of Ekurhuleni has a moderate likelihood of receiving extraordinary support from the South African government. 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 City of Ekurhuleni

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

Environmental considerations are important for the City of Ekurhuleni's credit profile. In line with the rest of South Africa, its main exposures are related to water shortage. South Africa is considered a water-scarce country; drought is the most frequent environmental constraint that directly hurts the city's revenue. This is managed through partnerships between the central government's Department of Water and Sanitation 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 the City of Ekurhuleni, have increased their focus on water-related infrastructure investment in their 2020-22 capital budgets.

Social considerations are important for 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. The 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 income inequality rates in the world, which filters through to the local governments in the country, creating risks of social unrest.

Governance considerations are important for the City of Ekurhuleni's credit profile. The city's administration has managed to implement prudent financial practices over the years, which led to the city attaining an unqualified audit opinion in fiscal 2019. Like all local governments in South Africa, the City of Ekurhuleni's financial undertakings are guided by the Municipal Finance Management Act and the national government, through the treasury, 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 websites.

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 Environmental, Social and Governance 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 scorecard-indicated BCA of ba1 reflects (1) an Idiosyncratic Risk score of 2 (presented below) on a scale of 1 to 9, 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

City of Ekurhuleni

[Regional and Local Governments](#)

Rating Factors						
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	1.10	12.5%	1.75	30%	0.53
Interest payments / operating revenues (%)	3	2.90	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	21.00	25%			
Short-term direct debt / total direct debt (%)	1	6.70	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

Fiscal 2019.

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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