

## CREDIT OPINION

3 August 2021

Update

✓ Rate this Research

### RATINGS

#### Ekurhuleni, City of

Domicile	South Africa
Long Term Rating	B2 , Possible Downgrade
Type	LT Issuer Rating - Dom Curr
Outlook	Rating(s) Under Review

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)

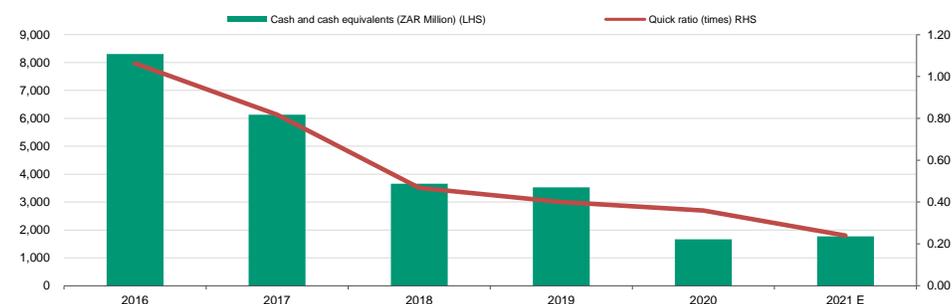
Update following the downgrade

## Summary

The credit profile of the [City of Ekurhuleni](#) (B2 rating on review) reflects its weak operating results, very weak liquidity profile (see Exhibit 1), and its rising debt — although debt is likely to remain in line with that of its peers in [South Africa](#) (Ba2 negative) that we rate. The credit profile also reflects the city's large and diverse economic base. The rating on review reflects the uncertainties surrounding the city's ability to withstand the deterioration in the operating environment caused by the ongoing structural economic weaknesses and the impact of the coronavirus pandemic, which is likely to constrain the city's financial performance by reducing revenue collection and exert additional consumer pressure.

Exhibit 1

**The City of Ekurhuleni's liquidity has been consistently declining over the past four years, and we expect it to remain constrained over the next three years**



2021 figures are estimates.

Sources: Issuer financials and Moody's Investors Service

## Credit strengths

- » Large economy, with a strong industrial base
- » Moderate debt levels compared with that of its peers we rate
- » Improving governance and management practice

## Credit challenges

- » Weak financial performance compared with that of its peers
- » Weak liquidity profile, exacerbated by the coronavirus impact
- » High capital spending pressure for service delivery

## Rating outlook

Placing the rating on review for downgrade reflects downside risks related to challenging operating environment and performance as revenue could fall short of our prior expectations whilst cash buffers diminish. The review period will allow us to assess the prospects for the city's operating balance, cash position, financing needs, as well as its ability to secure additional financing in the near to medium term. We will also assess the city's likely policy response and contingency planning in case of more pronounced revenue shortfalls than currently expected or constrained access to funding.

## Factors that could lead to an upgrade

Because the rating is placed on review for downgrade, an upgrade is currently unlikely. However, we could confirm the rating if the city faces only limited revenue shortfall and retains its current cash balances, and uses only secure and comprehensive funding.

## Factors that could lead to a downgrade

The city's rating could be downgraded if there were uncertainties around forthcoming financing and liquidity buffers were depleted further to levels not consistent with the current rating. Additionally, the rating would be under pressure if the Ba2 sovereign rating were to be downgraded.

## Key indicators

Exhibit 2

### The City of Ekurhuleni

	2016	2017	2018	2019	2020	2021 E	2022 B	2023 B
Net direct and indirect debt/Operating revenue (%)	18.0	14.3	15.7	21.0	22.8	28.4	28.1	32.7
Interest Payments/Operating Revenue (%)	3.3	3.3	3.1	2.7	3.3	2.6	2.5	2.5
Gross Operating Balance/Operating Revenue (%)	6.1	4.3	3.9	-1.1	1.1	10.8	10.4	10.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	1.9	-6.3	-9.4	-7.5	-7.9	-0.7	0.5	1.2
Intergovernmental Transfer/Operating Revenue (%)	16.2	17.2	16.7	16.4	17.3	16.5	16.1	15.9
Real GDP (% change) [1]	1.2	1.1	--	--	--	--	--	--
GDP per capita as % of National Average	142.3	135.6	135.6	--	--	--	--	--

[1] GDP at the provincial level.

Fiscal year ending 30 June.

Sources: City of Ekurhuleni and Moody's Investors Service

## Detailed credit considerations

On 16 July 2021, we downgraded the City of Ekurhuleni's long-term global scale issuer and debt ratings to B2/Baa3.za from B1/ A3.za and placed the rating on review for further downgrade to reflect the structurally very weak growth in the country, which we expect to further strain the municipalities' operations in the next three years because of their reliance on own-source revenue.

The credit profile, as expressed in its B2 rating, combines a Baseline Credit Assessment (BCA) of b2 and a low likelihood of extraordinary support from the national government in the event that the city faces acute liquidity stress.

### Baseline Credit Assessment

#### Weak financial performance compared with that of its peers

The City of Ekurhuleni posted a slightly improved operating surplus of 1.1% in the fiscal year that ended 30 June 2020 (fiscal 2020) (fiscal 2019: 1.1% deficit), according to its audited fiscal 2020 results. The improved operating performance is largely attributed to a 14% increase in operating grants from ZAR5.7 billion to ZAR6.4 billion in 2020, while key revenue drivers such as service charges and property rates grew by 7% and 5%, respectively. In its 2021-23 budget, the city has projected a highly ambitious operating surplus of 10% on average; however, this is unlikely considering our expectation of a further deterioration in the operating environment and the ongoing impact of the pandemic, which exert additional consumer pressure.

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With total revenue of ZAR39.3 billion (\$2.4 billion) in fiscal 2020, the City of Ekurhuleni ranks third in terms of total revenue among the six South African metropolitan municipalities we rate, following the [City of Cape Town](#) (Ba3 rating on review) and the [City of Johannesburg](#) (Ba3 rating on review). Discretionary own-source revenue contributed 82.7% of operating revenue in fiscal 2020, while only 17.3% of operating revenue were derived from government transfers. We expect revenue from service charges to be constrained because of lower services demand resulting of lower economic activity.

On the expenditure side, fixed costs such as bulk purchases and salary costs accounted for 66% of operating expenditure in fiscal 2020. The above expenditure line items will remain a larger part of the city's operating expenditure over the next three years at an average of 68% of operating expenditure, limiting the city's spending flexibility.

#### **Weak liquidity profile, exacerbated by the coronavirus impact**

The city's liquidity profile remains relatively weak compared with other peers in the country that we rate. The impact of the pandemic on the economy has exacerbated the City of Ekurhuleni's already weak liquidity. The city's cash balance declined to ZAR1.6 billion in fiscal 2020 from ZAR3.7 billion in fiscal 2019, largely driven by increase in capital expenditure and lower revenue collection. In addition, over the past three years the city used a significant amount of its cash reserves to fund capital spending, which also contributed to a deterioration of its cash reserves. According to the 2021 estimates, the city recorded a low cash balance of ZAR1.7 billion compared with the city's initial expectation of ZAR2.5 billion. As a result, the city's quick ratio declined to 0.24x according to 2021 estimates from 0.36x in fiscal 2020. We expect the city's liquidity to be constrained and remain weaker than that of its peers we rate over the next three years.

#### **High capital spending pressure for service delivery**

Despite having a high capital expenditure spending pressure, the city has implemented a 24% capital expenditure cut in its fiscal 2021-2023 period. This is done to replenish the city's cash reserves which has consistently been declining in the past three years. The city plans to invest only ZAR12.1 billion in capital infrastructure from fiscal 2021-2023 down from ZAR16 billion in fiscal 2018-2020. The capital budget will largely be funded from transfers and borrowing. However, significant reliance on borrowing could be challenging in the event of further deterioration in the operating environment which may lead lenders to tighten the borrowing requirements. Although reducing capital expenditure may ease liquidity pressure for the city in the short-term, it will exert additional spending pressure in the medium to long term, when considering the historical infrastructure backlog the city is facing.

#### **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'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 houses the Oliver Tambo International Airport, which is one of the major airports in Africa, and the city is building on this economic advantage to try and promote economic growth and job creation through projects related to transport and logistics.

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.

#### **Moderate debt levels compared with that of rated peers**

The City of Ekurhuleni's net direct and indirect debt gradually increased to 22.8% of operating revenue in fiscal 2020 from 21% in fiscal 2019. The city's overall level of indebtedness remains moderate compared with that of its rated peers in the country. The city issued new borrowing of ZAR1.9 billion in fiscal 2021, which increased the debt levels to 28.4% of operating revenue. The city's borrowing exposure should remain relatively low compared with that of its peers over the next three years, with net direct and indirect debt/operating revenue reaching 33% of operating revenue in 2023.

The City of Ekurhuleni's debt stock is relatively diversified, consisting of amortizing bonds (31%), bullet bonds (28%), bullet bank loans (24%) and amortizing bank loans (17%). In fiscal 2020-21, the City of Ekurhuleni redeemed two bullet bonds totaling ZAR1.6 billion. EMM01 (ZAR815 million), was redeemed in July 2020 and EMM02 (ZAR800 million) redeemed in March 2021 using sinking fund investments. As of 30 June 2021, the city's sinking fund had a closing balance of ZAR666 million. The redemption of the two bonds mitigated an increasing level of debt over the next three years. The next bullet payment of ZAR800 million (EMM03) is only due in May 2024 which should allow the city sufficient time to beef up its sinking fund investment.

**Improving governance and management practice**

The City of Ekurhuleni's administration has implemented a number of budget cuts including a 24% reduction in capital expenditure in fiscal 2021-2023. The city's management also plan to reduce expenditure such as removing free water services to those who can afford and a reduction of free water services to 6 kiloliters from 9 kiloliters and free electricity down to 50 kw from 100 kw in order to rebuilt its cash reserve. The city will also intensify the implementation of prepaid electricity meters and has also implemented a revenue enhancement strategy and appointed service providers to assist in collecting from other revenue streams. With some of these interventions, the city expects to save about ZAR250 million from water services and ZAR800 million from electricity sales in fiscal 2021-22. In fiscal 2020, the city achieved a clean audit outcome.

**Extraordinary support considerations**

The City of Ekurhuleni's likelihood of extraordinary support from the national government is low, reflecting, at the jurisdictional level, the national government's policy stance of promoting greater accountability for South African municipalities. This assessment is in line with the national government's stance to encourage municipalities to be self-sustainable. Although the legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bailout actions to avoid defaults on debt obligations.

## Rating methodology and scorecard factors

The City of Ekurhuleni's assigned BCA of b2 is close to the BCA of b1 generated by the scorecard. The scorecard-indicated BCA of ba3 reflects an Idiosyncratic Risk score of 6 (presented below) on a scale of 1 to 9, where 1 represents the strongest relative credit quality and 9 the weakest; and a Systemic Risk score of Ba2, 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

### The City of Ekurhuleni Regional & Local Governments

Baseline Credit Assessment – Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
<b>Factor 1: Economic Fundamentals</b>				<b>1</b>	<b>20%</b>	<b>0.20</b>
Economic Strength [1]	1	135.58%	70%			
Economic Volatility	1		30%			
<b>Factor 2: Institutional Framework</b>				<b>6</b>	<b>20%</b>	<b>1.20</b>
Legislative Background	5		50%			
Financial Flexibility	7		50%			
<b>Factor 3: Financial Position</b>				<b>5</b>	<b>30%</b>	<b>1.50</b>
Operating Margin [2]	5	0.85%	12.5%			
Interest Burden [3]	5	3.3%	12.5%			
Liquidity	9		25%			
Debt Burden [4]	1	22.8%	25%			
Debt Structure [5]	5	22.98%	25%			
<b>Factor 4: Governance and Management</b>				<b>9</b>	<b>30%</b>	<b>2.70</b>
Risk Controls and Financial Management	9					
Investment and Debt Management	5					
Transparency and Disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						<b>5.60 (6)</b>
<b>Systemic Risk Assessment</b>						<b>Ba2</b>
<b>Suggested BCA</b>						<b>b1</b>

[1] Local GDP per capita as % of national GDP per capita.

[2] Gross operating balance/operating revenue.

[3] Interest payments/operating revenue.

[4] Net direct and indirect debt/operating revenue.

[5] Short-term direct debt/total direct debt.

Sources: Moody's Investors Service and Ekurhuleni fiscal 2020

## ESG considerations

### How environmental, social and governance (ESG) risks inform our credit analysis of the City of Ekurhuleni

We take into account the impact of ESG 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. Similar to 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 challenge 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 are 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 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 has 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, 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. We also view the pandemic as a social risk under our ESG framework, given the impact for public health and safety in the City of Ekurhuleni. In addition, the resultant economic contraction and increase in unemployment lead to lower revenue collection rates and an increase in the number of indigent households.

Governance considerations are important for the City of Ekurhuleni's credit profile. The city's budget management practices have been weakening, leading to weak operating performance and liquidity. 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 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 ESG Risks, published in June 2021](#).

## Ratings

Exhibit 4

Category	Moody's Rating
<b>EKURHULENI, CITY OF</b>	
Outlook	Rating(s) Under Review
Issuer Rating -Dom Curr	B2 <sup>1</sup>
NSR Issuer Rating	Baa3.za <sup>1</sup>
Senior Unsecured -Dom Curr	B2 <sup>1</sup>
NSR Senior Unsecured	Baa3.za <sup>1</sup>
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	P-3.za <sup>1</sup>

[1] Placed under review for possible downgrade on 16 July 2021

Source: Moody's Investors Service

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