GCR RATINGS

CREDIT RATING ANNOUNCEMENT

GCR places the City of Ekurhuleni ratings of BBB(ZA)/ A3(ZA) on Negative Outlook, given the ongoing financial constraints and political instability within the Metro

Rating Action

Johannesburg, 26 April 2023 – GCR Ratings ("GCR") has affirmed the national scale long and short term issuer ratings assigned to City of Ekurhuleni at BBB(ZA) and A3(ZA) respectively. The outlook has been revised to Negative from Stable.

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook / Watch
City of Ekurhuleni	Long Term Short Term	National National	BBB(ZA) A3(ZA)	Negative Outlook

Rating Rationale

The revision in the rating outlook to Negative for City of Ekurhuleni ("Ekurhuleni" or "the Metro") reflects the financial constraints and political instability impacting the municipal sector in South Africa. Ekurhuleni has also been impacted by these challenges, which have affected operating performance and liquidity, although it has balanced its income and expenditure better than most similar metropolitan municipalities.

The South African municipal sector is experiencing a number financial and political challenges. Rates and service tariffs have been rising faster than inflation and are expected to see even sharper increases in 2023 and 2024 as Eskom implements high tariff increases. As such, residents have increasingly struggled to meet monthly payments to municipalities, resulting a weak debtors collection levels. Financial institutions have also become much more reluctant to lend to municipalities, given the deteriorating financial position. These problems have been exacerbated by political instability within many municipalities, negatively impacting the various councils' ability to address short term challenges, as well as implement long term planning for financial sustainability.

Ekurhuleni's operating and financial recovery has been hampered by the above factors. Although overall revenue climbed to R45bn in FY22 (FY22: R41.3bn), this was driven by escalations in rates and service tariffs. Actual grant income, including operating grants declined. Evidencing the significant pressure this has placed on residents, the overall collection rate has remained at around 85%, below the projected 90% used for budgeting. While commercial and industrial collections remain around 98%, residential collections averaged just 65% since January 2022. As a result, the bad debt charge rose by 17% in FY22, following a 12% increase in FY21. With less disposable income available to Ekurhuleni's population, and the steep tariffs to be implemented by Eskom, GCR expects debtors collections to continue to underperform the budgeted rate of 90% over the medium term.

Containing expenditure remains a key focus for Ekurhuleni, with mixed success reported. Staff costs increases have been maintained at a moderate 3% over the past two years, whilst general expenses have risen in line with inflation. However, high inflation and public sector wage increases will place renewed pressure on expenditure. As a result, maintaining small operating surpluses, as were reported in FY21 and FY22, will be difficult over the medium term, which could hinder cash generation.

As a consequence of constrained cash inflows, capex has steadily reduced from a high of R6bn in FY19 to R3.1bn in FY22. Around R3.2bn is forecast for FY23, but thereafter it will fall to around R2.7bn as Ekurhuleni has indicated that it will not raise external debt. Debt funding has supported between R500m and R1bn in capex in over the past three years.

Ekurhuleni's gearing and capital structure is considered moderately weak. Gross debt has remained relatively stable, at between R10bn and R10.5bn since FY20 (FY22: R10.4bn), with net debt to EBITDA low at 21% (FY21: 21%). However, unfavorable working capital movements due to rising debtors have seen cash flow based metrics deteriorate. Operating cash flow coverage of interest decreased to 3.4x at FY22 (FY21: 4.5x), whilst cash flow coverage of net debt fell to 26% (FY21: 36%). Although Ekurhuleni has demonstrated some access to capital, with R1bn raised during FY22 and R741m to be drawn before year end FY23, this has been drawn solely from the Development Bank of South Africa (DBSA). Private sector financial institutions have been reluctant to extend new facilities, or terms have been onerous. Gross debt is expected to decrease over the medium term as Ekurhuleni has indicated that it will not draw new debt. However, a return to stronger gearing metrics is dependent on firmer cash generation.

Liquidity pressure is expected to remain very tight, with GCR's calculated liquidity coverage at 1x if financial projections are met. Ekurhuleni is budgeting for small operating surpluses, which will be used to meet interest payments and capex costs, whilst most of the capex spend will be covered by conditional grant funding. However, this is dependent on an improvement in collections to the 90% level, which if not achieved, will force the Metro to further reduce some expenditure, with a negative impact on service delivery. Positively, the Metro has been settling service providers, including Eskom and Rand Water within its 30-day payment terms. Even if budgets are achieved, cash resources will remain low, at around the R1bn level, translating into very low days cash coverage of around 10 days, well below National Treasury's guidelines of 30-90 days. Positively, the Metro has accumulated in its sinking fund most of the funding required to redeem its R800m bond in May 2024, removing this key source of liquidity risk.

GCR has also included a positive peer adjustment as Ekurhuleni is the only metropolitan municipality to have received a clean audit outcome. This points to enhanced levels of operational controls within the Metro, which should support initiatives to strengthen the financial position.

Outlook Statement

The Negative outlook reflects the risk that the ongoing financial challenges faced by Ekurhuleni will further erode liquidity and limit its ability to deliver infrastructure and services to residents. In addition, renewed political instability presents a risk to the implementation of its recovery programme.

Rating Triggers

The rating could be downgraded if there is a further deterioration in operating performance as evidenced by rising expenditure or an inability to collect revenue, particularly if negative cash outflows result. In addition, negative action could be taken if the Metro is unable to meet debt repayment and amortisation obligations as they arise and if the political turmoil continues, thus preventing it from implementing a recovery plan.

A return to a stable outlook is dependent on demonstrated progress in improving the finical position and greater political stability. Positive rating action is only possible if there is a meaningful improvement in operating performance that results in improving cash flows and the rebuilding of cash reserves.

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Related Criteria and Research

Criteria for the GCR Ratings Framework, January 2022
GCR Rating Scales Symbols and Definitions, May 2022
Criteria for Rating Local and Regional Governments, June 2019
GCR's Country Risk Scores, March 2023

Ratings History

City of Ekurhuleni					
Rating class	Review	Rating scale	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	BBB(ZA)	Stable Outlook	April 2023
Short Term Issuer		National	A3(ZA)		
Long Term Issuer	Last	National	BBB(ZA)	Stable Outlook	April 2023
Short Term Issuer		National	A3(ZA)		

Risk Score Summary

Rating Components & Factors	Risk scores
Operating environment	**13.75**
Country & sector risk score*	14.00
Adjustment	(0.25)
Business profile	**(0.25)**
LRG Profile	1.25
Operating performance	(1.50)
Management & governance	0.00
Financial profile	**(3.50)**
Leverage and capital structure	(1.00)
Liquidity	(2.50)
Comparative profile	**0.50**
Government support floor	0.50
Peer analysis	0.00
Total score	**10.50**

*The country risk score serves as a proxy for sector risk.

Glossary

Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Capital	The sum of money that is invested to generate proceeds.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.

Diversification	Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long Term Rating	See GCR Rating Scales, Symbols and Definitions.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.

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The credit ratings have been disclosed to the rated entities. The ratings above were solicited by, or on behalf of, the rated entities, and therefore, GCR has been compensated for the provision of the ratings.

The rated entities participated in the rating process via face-to-face management meetings, as well as other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from the rated entity and other reliable third parties to accord the credit ratings included:

- Audited 2022 financial results (plus four years of comparative, audited financials)
- Auditor General report for June 2022
- YTD accounts to 31 January 2023
- Adjusted Medium Term Revenue and Expenditure Framework 2023 to 2025
- The Integrated Development Plan 2023;

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