GCR RATINGS

CREDIT RATING ANNOUNCEMENT

GCR affirms the City of Ekurhuleni Metropolitan Municipality's rating of BBB(ZA. The ratings remain on Negative Outlook given ongoing financial constraints and weak liquidity.

Rating action

Johannesburg, 16 April 2024 – 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 maintained on Negative.

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 Negative outlook for City of Ekurhuleni (Ekurhuleni or the Metro) continues to reflect the ongoing financial constraints and political uncertainty impacting the South African municipal sector. Ekurhuleni has not been immune to these challenges, which continue to pressure its operating performance and liquidity. However, as the Metro has managed to balance its income and expenditure with little further erosion to its performance, GCR has affirmed the ratings.

The South African municipal sector remains susceptible to several financial and political challenges. Rates and service tariffs have been rising faster than inflation and are expected to see even sharper increases in 2025 as Eskom implements high tariff increases. Ekurhuleni's operating and financial recovery has been hampered by these factors, and accordingly its financial profile remains relatively weak, with stagnant operating performance translating into a still tight liquidity profile. Although total income, including capital grant funding, increased to ZAR50.4 billion in its fiscal year to 30 June 2023 (fiscal 2022: ZAR45.5 billion), this was driven predominantly by higher service tariffs, However, operating margins across key income lines were much weaker, stemming mainly from inflationary pressures, the diesel costs associated with running generators during loadshedding and the provision of water tankers during the numerous water outages. Thus general expenditure rose 14.7%, but the Metro reported another small (albeit narrower) operating surplus of ZAR562 million in fiscal 2023 (fiscal 20222: ZAR613 million). The Metro's success in containing expenditure will remain critical to its ability to continue to generate increasing cash flows and its financial recovery.

As rates and service tariffs have been rising faster than inflation, residents have increasingly struggled to meet monthly payments to municipalities, resulting in weak debtors' collection levels. Commercial and industrial collections remained around 97%, but residential collections averaged just 65% during fiscal 2023. As a result of these weak residential collections, the bad debt impairment rose significantly to ZAR7.7 billion in fiscal 2023, from ZAR4.9 billion in fiscal 2022. GCR positively views the improvement in Ekurhuleni's overall collection rate in fiscal 2023 to 90.7% (fiscal 2022: 85%), albeit that it remains below the c.92% levels evidenced pre-COVID-19. Current revenue budgets reflect further tariff increases (particularly electricity at c.12%) and are predicated on a collection rate of 90%. However, as economic challenges intensify and Eskom continues to implement steep tariff increases leaving Ekurhuleni's population with less disposable income, GCR expects debtors collections to underperform the budgeted rate of 90% over the medium term.

As a consequence of constrained cash inflows, capex has steadily reduced from a high of ZAR6 billion in fiscal 2019, to ZAR3.0 billion in fiscal 2023. A lower ZAR2.7 billion and ZAR2.8 billion have been forecast for fiscal 2024 and 2025 respectively, to be primarily funded by grants. Debt funding has supported between ZAR500 million and ZAR1 billion in capex over the past 4 years but Ekurhuleni has indicated that it is unlikely to raise new external debt over this period. We consider the lower capex spend to be a medium to long term concern as ongoing capital infrastructure developments are required for a metro of its size to ensure efficient service delivery. GCR also negatively views the low quantum of repairs and maintenance carried out during fiscal 2023 (registering at 6% of total expenditure, below the 8% National Treasury Guideline) and considers this likely to impede service delivery over the rating horizon.

Ekurhuleni's gearing and capital structure is considered moderately weak. Gross debt has remained relatively stable, at between ZAR10 billion and ZAR10.5 billion since fiscal 2020 (fiscal 2023: ZAR10.3 billion), with the marginal improvements in cash flow resulting in net debt to income register at a low at 17% (fiscal 2022: 21%). Operating cash flow coverage of interest improved somewhat to 4.5x at fiscal 2023 (fiscal 2022: 3.4x), whilst cash flow coverage of net debt increased to 32% (fiscal 2022: 23%). Although Ekurhuleni has demonstrated some access to capital, with a 7-year ZAR741 million term loan being raised during fiscal 2023, this was drawn solely from the Development Bank of South Africa (DBSA). Private sector financial institutions have been reluctant to extend new facilities, or terms offered have been onerous. Gross debt is expected to decrease over the medium term as Ekurhuleni has indicated that it will not draw new debt.

Liquidity pressure is expected to remain very tight. Even if budgets are achieved, cash resources will remain low translating into very low days cash coverage of around 15 days, well below National Treasury's guidelines of 30-90 days. Further the current ratio is currently at a low 0.88x (fiscal 2022: 0.88x) highlighting the financial risk of the Metro being unable to pay down its short term obligations. Positively, the Metro has been settling service providers, including Eskom and Rand Water within its 30-day payment terms. The Metro has also accumulated in its sinking fund sufficient funding to redeem its ZAR800 million bond in May 2024, removing this key source of liquidity risk.

GCR had historically also included a positive peer adjustment as Ekurhuleni had been one of the few metropolitan municipalities to have received a clean audit outcome. As the Metro did not receive a clean audit outcome from the Auditor General for its fiscal 2023 financials, this has been removed in this year's rating.

Outlook statement

The Negative outlook reflects the risk that the ongoing financial challenges faced by Ekurhuleni could further erode liquidity and limit its ability to deliver infrastructure and services to residents. In addition, renewed political instability around the upcoming elections presents a risk to the implementation of its recovery programme. Ongoing disruptions from loadshedding and water shortages are also expected to continue to impact the Metro's operating performance.

Rating triggers

The rating could be downgraded if there is a 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's liquidity position deteriorates such that 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. Moreover, any further deterioration in the Auditor General's audit reports could also see the ratings being lowered.

A return to a stable outlook is dependent on continued progress in improving and stabilising the financial position and cash flows. Evidence of political stability and adequate management and governance measures would also be required.

Analytical contacts

Primary analyst	Lara Krug	Senior Analyst: Corporate & Public Sector Ratings
Johannesburg, ZA	larak@GCRratings.com	+27 11 784 1771
Secondary analyst	Sheri Morgan	Deputy Sector Head: Corporate & Public Sector
Johannesburg, ZA	Morgan@GCRratings.com	+27 11 784 1771
Committee chair	Eyal Shevel	Senior Analyst: Financial Institutions Ratings
Johannesburg, ZA	Shevel@GCRratings.com	+27 11 784 1771

Related criteria and research

Criteria for the GCR Ratings Framework, January 2022
GCR Rating Scales, Symbols and Definitions, May 2023
Criteria for Rating Local and Regional Governments, June 2019
GCR's Country Risk Scores, March 2024

Ratings history

Rating class	Review	Rating scale	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	BBB(ZA)	Stable Outlook	April 2022
Short Term Issuer		National	A3(ZA)		
Long Term Issuer	Last	National	BBB(ZA)	Negative Outlook	April 2023
Short Term Issuer		National	A3(ZA)		

Risk score summary

Rating Components & Factors	Score
Operating environment	**13.75**
Country and sector risk score*	14.00
Adjustment	(0.25)
Business profile	**(0.25)**
LRG profile	1.25
Operating performance	(1.50)
Management and governance	0.00
Financial profile	**(3.50)**
Leverage & capital structure	(1.00)
Liquidity	(2.50)
Comparative profile	**0.00**
Government support floor	0.00
Peer analysis	0.00
Total Risk Score	**10.00**

*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.

Salient points of accorded rating

GCR affirms that a.) no part of the rating process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit ratings have been disclosed to the rated entity.

The ratings above were solicited by, or on behalf of, the rated entity.

The information received to accord the credit ratings included:

- City of Ekurhuleni Audited 2023 financial results (plus four years of comparative, audited financials)
- City of Ekurhuleni Auditor General report for June 2023
- City of Ekurhuleni Adjusted Medium Term Revenue and Expenditure Framework 2024 to 2026
- City of Ekurhuleni Integrated Development Plan 2024
- City of Ekurhuleni Annual Report for June 2023

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