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Why Has the Credit Rating of Zagrebački Holding Been Downgraded?

Anto Bajo, PhD

1 Introduction

On Friday, 22 November 2008, credit ratings agency Moody's lowered its ratings for Zagreb Utility Holding company (hereinafter: Holding) from Baa2 to Baa3 (from medium to lower solvency level) and for the City of Zagreb from Baa1 to Baa2 (from higher to medium solvency level). The ratings were downgraded owing to high indebtedness of the Holding and its poor debt repayment prospects, and they mainly reflect deterioration of the Holding's financial position. Despite the City's low direct debt, its exposure to the financial operations of the Holding is considerable and even rising. As a result, the rating of the City of Zagreb was downgraded, as the Holding needed subsidies and City budget guarantees. Over the last two years, the Holding launched large-scale capital investments which almost tripled its debt from 2006. The fall in the City's and Holding's ratings was the result of the latter's heavy indebtedness which impacted directly on the City's financial and credit positions. This raises the question of the soundness and financial performance of utility companies within the Holding, particularly of the influence of the Holding's borrowings on the City budget debt.¹

2 The City of Zagreb Budget and the Holding Budget - connected or separate

The Holding consists of 22 companies wholly-owned by the City of Zagreb, whose operations are governed by the Companies Law and which are subject to profit tax and value added tax. The Holding is mostly financed by special-purpose revenues (over 50%), which is why it could enjoy the status of an extra-budgetary user (fund) of the City of Zagreb. In such a case, the Holding's financial plan (budget) could also be subjected to the formal approval procedure of the City Assembly, like the City budget.

The City budget and the Holding budget do not act as communicating tubes. The City Government proposes, and the City Assembly adopts the budget, but not the financial plan of the Holding. The bulk of the City's capital transactions was carried out through the Holding budget, which is adopted by the Supervisory Board and submitted for examination to the Holding's Assembly (the only member of this Assembly is the mayor as a

¹ The analysis is based on the data from the City of Zagreb statement of revenues and expenditures for the period 2002-2007 (<http://www.mfin.hr>), and on financial reports of Zagrebacki holding d.o.o. including the external auditor's report of 31 December 2007, available at <http://www.zagrebackiholding.com/Default.aspx?tabid=281>.

representative of the City Council). Once in a year, the representatives of the Holding submit a business report for the previous year to the City government which examines the report and delivers it to the City Assembly. Consequently, the Holding's financial plan and financial operations (budget) report are not subject to the same formal procedure (preparation, approval, execution and auditing) as the City budget². Therefore, there is no overall consolidated budget to include not only the City budget but also the budget (report on financial operations) of the Holding, showing the size and structure of assets, total debt and overall financial position of the City of Zagreb (i.e. of both the City and Holding's budgets).

In order to gain a full picture of the City's assets, financial operations and, particularly, the size of its debt incurred through the Holding, financial statements of both the City and Holding need to be consolidated. Technically, this should pose no problem, as the Holding is owned by the City. However, given the status of the Holding as a company, this is not currently possible.

Financial transactions between the City and the Holding are based on the principle of communicating vessels, as budget funds are transferred in the form of subsidies, but also in the form of guarantees on the Holding's borrowings. It is worth noting that the City budget subsidies to the Holding rose from 477 million kuna in 2002 to 670 million kuna in 2007. In the period 2002-2007, the City budget subsidies to the Holding reached 3.4 billion kuna, whereas the guarantees issued amounted to 1.4 billion kuna.

3 The City's Budget Debt and Borrowing

The direct budget debt is low, as the City sticks to the borrowing limitations. However the bulk of debt is incurred by the Holding, used by the City for bypassing the Government's budgetary constraints. In the period 2002-2007, the City's lending to its own companies decreased, as did the revenues from debt collection. However, it is questionable whether this was due to a favourable financial position of the City or just due to a shifting of debt from the City budget to the Holding. A complete answer to this would require separate financial position analyses of both the City and Holding, and a detailed examination of the terms and structure of the Holding's borrowing in 2006 and 2007.

Financial Position of the City Budget

The City's financial position, measured by its net financial assets or by the difference between its liquid financial assets (cash at bank, deposits, loans extended and securities) and its (credit) liabilities, is satisfactory. There are no major liquidity problems, and the existing liabilities of the City budget are fully covered by the disposable cash deposited in the commercial bank account.

Table 1. Financial Position and Liquidity of the City of Zagreb Budget, 2005-2007 (in mil. kuna), end-of period

| | | 2005 | 2006 | 2007 |
|----------------|-----------------------------|-------------|-------------|-------------|
| 1 | Financial assets | 820 | 539 | 593 |
| | Cash at bank and vault cash | 628 | 374 | 481 |
| | Deposits and claims | 85 | 65 | 60 |
| | Loans | 63 | 61 | 20 |
| | Securities | 45 | 39 | 32 |
| 2 | Loans liabilities | 481 | 349 | 350 |
| (1 - 2) | Net financial worth | 339 | 191 | 242 |

² The audit of the Holding's financial operations in 2007 was carried out by a private audit firm. The City budget is audited by the State Audit Office.

Source: The City of Zagreb financial statements for 2008.

The City's net financial position is positive and, after covering its loans liabilities, the remaining liquid financial assets of the City amount to 240 million kuna. However, financial difficulties may result from issuing guarantees on the Holding's borrowings, which may be called in the case of its unfavourable financial position. In 2007, the City's guarantees on the Holding's borrowings amounted to 1.4 billion kuna, an additional amount of 200 million kuna being issued in that year.

Direct (credit) liabilities of the City total 350 million kuna. However, the City has also issued guarantees to the amount of 1.4 billion kuna, so that the total (direct and potential) budget debt stands at 1.75 billion kuna. Given the issued guarantees, the financial position can be threatened should the Holding not be able to repay the interest or principal of the debt.

Table 2 The City's Net Financial Position (in million kuna), end-of-period

| | | 2005 | 2006 | 2007 |
|--------------|---|-------------|-------------|---------------|
| 1 | Financial assets | 820 | 539 | 593 |
| 2 | Direct and potential financial liabilities | 481 | 349 | 1,713 |
| | Loans liabilities | 481 | 349 | 350 |
| | Stock of active guarantees | 0 | 0 | 1,363 |
| (1-2) | Net financial worth | 339 | 191 | -1,121 |

Source: Author's calculations based on the City of Zagreb financial statements.

Under a more pessimistic scenario, the City would still be faced with a debt of about 1.1 billion kuna. Therefore, attention should be focused on the quality of operations and sustainability of the Holding in order to prevent it from becoming a direct impediment to the financing of basic municipal services.

4 The Holding's Financial Position: Does the Holding Pose a Threat to the City Budget?

Potential instability of the City finances may be caused by financial operations of the Holding. Its revenues rose from 3.3 billion kuna in 2006 to 4.3 billion in 2007. Nevertheless, it is not clear whether they resulted from actual growth or just from a broadened scope and stronger revenue consolidation of all companies within the Holding. Expenses were lower than revenues, so that the Holding's budget before tax recorded surpluses (profit), dropping, though, from 88 million kuna in 2006 to 30 million in 2007.

Table 3 The Holding's Budget (in million kuna)

| | 2006 | 2007 |
|--------------------------|-------------|-------------|
| Operating revenue | 3,252 | 4,150 |
| Financial revenue | 89 | 156 |
| Total revenue | 3,341 | 4,306 |
| Operating expense | 3,132 | 4,044 |
| Financial expense | 121 | 231 |
| Total expense | 3,253 | 4,276 |
| Surplus/deficit | 88 | 30 |

Source: The Holding's Financial Statement, 2008.

At first sight, these data suggest stable financial operations. However, in the two observed years, the Holding increased its borrowing both from domestic banks and foreign financial institutions. Total debt of the Holding rose from 1.4 billion kuna in 2006 to 4 billion in 2007. The considerable debt increase in 2007 arose from a 2 billion kuna worth issue of bonds at the London Stock Exchange. Let us now consider the Holding's main debt indicators for 2006 and 2007.

Table 4 The Holding's debt indicators (in billion kuna)

| | 2006 | 2007 |
|-----------------------|-------------|-------------|
| Total revenues | 3.3 | 4.3 |
| Capital and reserves | 6.9 | 6.9 |
| Share capital | 4.3 | 4.2 |
| Total debt | 1.4 | 4.0 |
| Debt as % of | | |
| total revenues | 43 | 93 |
| capital and reserves | 21 | 59 |
| share capital | 33 | 95 |

Source: The Holding's Financial Statement for 2008.

In 2007, the Holding's debt accounted for 93% of the revenues and 95% of the company's share capital (the City of Zagreb participates with 4.2 billion kuna in the Holding's ownership). In terms of maturity, 91% of the debt had long maturity (over 10 years), whereas 9% related to short-term liabilities (up to one year). In 2007, 55% of debt was owned by foreign and 45% by domestic creditors. These were mainly long-term liabilities maturing by 2017. Most loans liabilities of the Holding (94%) were in euros.

Below we present the structure of major debtors within the Holding.

Table 5 Major debtors within the Holding (in million kuna), end-of-period

| | Debt amount (in million kuna) | | Percentage (%) | |
|---------------------------------------|--|--------------|---------------------------|-------------|
| | 2006 | 2007 | 2006 | 2007 |
| Zagreb Municipal Transit System (ZET) | 858 | 1,005 | 60 | 25 |
| Water Supply and Sanitation | 293 | 277 | 21 | 7 |
| Sljeme, Medvednica | 32 | 28 | 2 | 1 |
| Cargo Terminal Zagreb | 84 | 259 | 6 | 6 |
| Zagreb Parking | 27 | 124 | 2 | 3 |
| ZGOS – Waste Collection and Removal | 127 | 90 | 9 | 2 |
| Zagreb Roads | 9 | 2 | 1 | 0 |
| Čistoća (Waste Disposal) | 0 | 35 | 0 | 1 |
| Euro Bonds | 0 | 2,198 | 0 | 55 |
| Total | 1,430 | 4,018 | 100 | 100 |

Source: The Holding's Financial Statement for 2008.

Taken individually, the largest debtors within the Holding are the ZET (1 billion kuna) and Water Supply and Sanitation (277 million kuna).

Borrowing Terms, Maturity, Interest Rates and Collateral

During the observed period, the Holding borrowed from domestic banks on unfavourable terms. Average interest rates stood at about 7%. However, the rate demanded by the HBOR was 7.2%, and the rates demanded by some domestic banks even exceeded 9%³. Apart from fixed interest rates, some loans taken on by the Holding were also based on quarterly LIBOR or Euribor rates.

³ According to the CNB data, average weighted interest rates on long-term loans with a currency clause stood at 5.77% and 6.15% in 2006 and 2007 respectively. Interest rates on euro loans were 5.34% in 2006 and 5.65% in 2007 (available at: <http://www.hnb.hr/statistika/hstatistika.htm>).

The Holding's loans are additionally collateralised by its assets (liens on movables and immovables), as well as debentures, bills of exchange, acceptance orders and readily cashable instruments. A part of the Holding's debt is additionally guaranteed by the City.

One of the most favourable types of borrowing used by the Holding is a bond issue of 300 million euros at the London Stock Exchange, at an interest rate of 5.6% which is payable annually. Under the borrowing terms, the Holding is not required to offer any additional guarantees, like those demanded by domestic financial institutions.

The State Audit Office's Review of Guarantees Issued by the City

As at end-2006, the stock of active guarantees stood at 1.7 billion kuna. In 2002, a guarantee of 840.5 million kuna was issued to the municipal transport company for the successive utilisation of a loan up to the end of 2006 (640 million kuna or 76% of the loan was used by end-2006). In the period from 2002 to 2006 there was no principal repayment. The explanation provided together with the City Assembly decision suggested that this was not a guarantee but actually a loan taken on by the City, because the funds for the company's loan repayment should have been provided in the City budgets for the period 2002-2006. From 2004 to 2006, funds for the repayment of loans related to the guarantees issued, amounting to 146.5 million kuna were transferred to the companies, but they failed to declare them in their loan repayments related to the issued guarantees and given approvals (<http://www.revizija.hr>).

The Holding's Financial Position

A comparison between the disposable financial assets and financial liabilities provides a basis for a framework financial position of the Holding in 2006 and 2007: the Holding's net financial position deteriorated.

Table 6 The Holding's net financial position (in million kuna), end-of-period

| | 2006 | 2007 |
|---|---------------|---------------|
| Securities | 2 | 1 |
| Loans, deposits ⁴ , caution money | 160 | 0 |
| Other short-term investments | 0 | 0 |
| Vault cash, cash in giro-account and cash at bank | 154 | 435 |
| 1 Total financial assets | 315 | 435 |
| Loans | 1,430 | 1,821 |
| Bonds | 0 | 2,198 |
| 2 Total financial liabilities | 1,430 | 4,019 |
| 3 Net financial worth (1-2) | -1,115 | -3,583 |

Source: The Holding's Financial Statement for 2008.

In 2006, the Holding recorded a financial assets gap of 1.1 billion kuna, which widened to as much as 3.6 billion kuna in 2007. This was due to new borrowing for the financing of capital projects like the sport hall Zagreb Arena, and perhaps even for current expenditure financing. As a result of incurred liabilities, the Holding's liquidity level is low.

⁴ Due to a one-off effect on financial assets growth, deposits do not include receipts from borrowing deposited for a fixed period with banks (see notes to the Holding Company's financial statements, p. 43 (in Croatian), available at: <http://www.zagrebackiholding.com/Default.aspx?tabid=281>) until activating the payment of capital project financing liabilities in 2008 and 2009.

5 Conclusion

The financial operations analysis leads to the conclusion that the future financing of the City will greatly depend on the financing stability of the Holding. Utility service prices might go up, as might the City subsidies for debt repayment, because the Holding's liabilities to domestic and foreign creditors account for about 95% of its share capital. Generally, it is not clear why the City of Zagreb previously refrained from borrowing in the form of bond issue, but rather took on loans from domestic financial institutions on unfavourable terms. While it is not uncommon that a private company's liabilities exceed its share capital, companies owned by units of local self-government (including the state) having a monopoly on the provision of public services often tend to shift their debt repayment burden directly to citizens through higher services prices.