

## CREDIT OPINION

6 April 2020

### Update

 Rate this Research

#### RATINGS

##### Johannesburg, City of

Domicile	Johannesburg, South Africa
Long Term Rating	Ba1
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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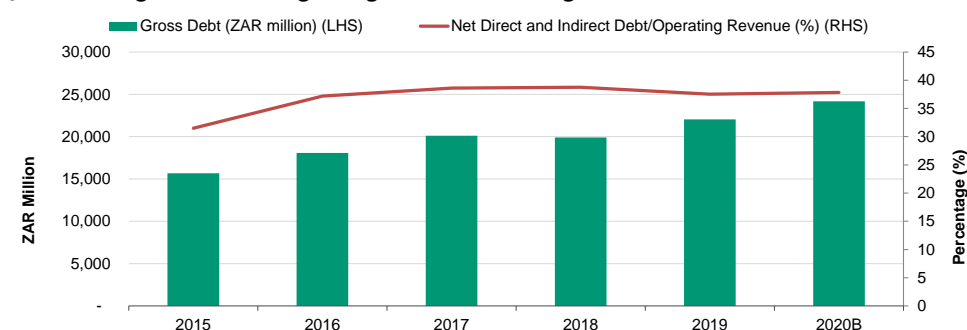
## City of Johannesburg (South Africa)

### Update following rating downgrade to Ba1

The credit profile of the [City of Johannesburg](#) (Ba1 negative) reflects the city's status as [South Africa's](#) (Ba1 negative) business capital and main financial and economic centre, which allows it to access a broad tax base. The city's credit profile also reflects the challenges associated with its high infrastructure backlog and rapid population growth, which strain its capital infrastructure plans. Nonetheless, the credit profile incorporates the city's moderate debt levels, and improving liquidity and operating performance. The negative outlook reflects the weakening of the credit profile of its support provider, the Government of South Africa. The coronavirus outbreak and the associated deterioration in the global and national economic outlook will also likely constrain the city's financial performance through lower revenue collection as a result of higher unemployment.

Exhibit 1

#### Johannesburg's debt stock is growing but remains manageable



Fiscal year ending 30 June.

Source: Moody's Investors Service and City of Johannesburg's financials

### Credit strengths

- » Improving operating performance, supported by a large tax base
- » Improving liquidity
- » Sophisticated financial management
- » Large and diversified economic base

### Credit challenges

- » Increasing debt stock, although the debt ratio will remain relatively stable
- » High capital spending plan

## Rating outlook

The negative rating outlook reflects the weakening of the credit profile of the city's support provider, the Government of South Africa, taking into account the strong operational and financial links between the two.

## Factors that could lead to an upgrade

Given the negative outlook, an upgrade is unlikely at this time. The rating could be changed to stable if the outlook on the sovereign rating were to change to stable from negative.

## Factors that could lead to a downgrade

The rating could be downgraded in the event of a downgrade of the Ba1 sovereign rating. Additionally, the city's rating could be downgraded if its liquidity and financial performance were to deteriorate.

## Key indicators

Exhibit 2

### City of Johannesburg

	2015	2016	2017	2018	2019
<b>City of Johannesburg</b>					
Net direct and indirect debt/Operating revenue (%)	31.5	37.2	38.6	38.8	37.5
Interest Payments/Operating Revenue (%)	4.2	4.7	5.7	5.7	4.7
Gross Operating Balance/Operating Revenue (%)	6.2	7.5	2.2	5.4	12.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	-6.0	-6.0	-6.8	-1.1	2.0
Intergovernmental Transfer/Operating Revenue (%)	15.2	14.6	15.5	16.0	15.2
GDP Growth (% change) [1]	1.3	1.4	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 Johannesburg's financials

## Detailed credit considerations

[On 1 April 2020, we downgraded the City of Johannesburg's global scale ratings to Ba1/NP from Baa3/P-3 and maintained the negative outlook.](#) The downgrade of the city's ratings reflects the challenges emanating from the weakening of the sovereign credit profile. We view the centralised nature of the regional and local government (RLG) sector in South Africa and the close financial links between the national government and the RLGs as factors that keep the city's ratings at par with the sovereign bond rating. At the same time, we affirmed the long-term and short-term national scale issuer and debt ratings at Aa1.za/P-1.za.

The credit profile of the City of Johannesburg, as expressed in its Ba1/NP negative global scale ratings, combines (1) the city's Baseline Credit Assessment (BCA) of ba1, and (2) a low likelihood of extraordinary support from the national government if the city faces acute liquidity stress.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

## Baseline Credit Assessment

### Improving operating performance, supported by a large tax base

Johannesburg is South Africa's largest city in terms of budget, with total revenue of ZAR56 billion, according to the city's financials for the fiscal year ended 30 June 2019 (fiscal 2019). The city's operating revenue grew by 17%, driven by a 36% increase in property rate revenue in fiscal 2019 (15% in fiscal 2018), an 11% increase in service charges (1% in fiscal 2018) and a 10% increase in grant funding. This growth improved its gross operating balance to 12.3% of operating revenue in fiscal 2019, compared with 5.4% in the previous year. We expect key revenue drivers such as property rates and service charges, including water and electricity sales, to continue to drive the city's growing tax base over the next three years.

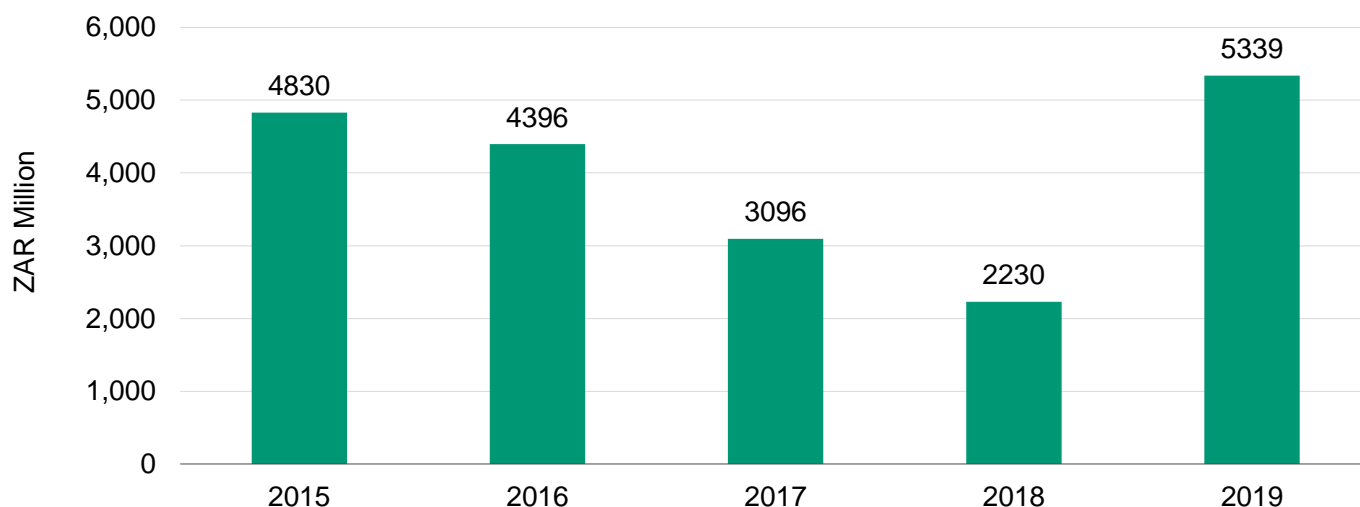
Discretionary own-source revenue contributed 84% of operating revenue in fiscal 2019, reflecting the city's high revenue flexibility, and its large and steadily growing tax base. On the spending side, rigid cost items such as bulk purchases and salary costs represented a high 65% of operating expenditures in fiscal 2019, limiting the city's ability to reduce its operating expenditures. The city's cost containment strategies have also yielded positive outcomes. In fiscal 2019, Johannesburg's overall operating expenditures grew only by 9%, although the city insourced around 4,000 employees. Salary costs, which increased by 19% as a result of insourcing, only contributed 28% to the city's operating expenditures.

### Improving liquidity

The prudent financial management strategies implemented in 2018 significantly improved the city's liquidity, as indicated in the financial statements for fiscal 2019. This improvement resulted in an increase in net cash flow from operating activities, which increased to ZAR8.6 billion in fiscal 2019 from ZAR4.9 billion in fiscal 2018. As a result, the city's cash balances increased to ZAR5.3 billion as of the end of fiscal 2019 from ZAR2.2 billion as of the end of fiscal 2018. The city has access to approved credit line facilities of ZAR3.7 billion from the [Development Bank of Southern Africa](#) (DBSA, Ba1 negative) and [Standard Bank Group Limited](#) (Ba2 negative). As a result of the improvement in its liquidity, the city only used ZAR1.5 billion of the facility from DBSA in fiscal 2019, compared with ZAR3 billion used in fiscal 2018.

The city expects its cash collection from property rates and service charges to amount to ZAR40 billion in fiscal 2020. Although the city plans to increase capital spending over the next three years, of which 26% will be financed through its own funds in fiscal 2020, we do not expect this plan to have a significant impact on its liquidity.

Exhibit 3

**City of Johannesburg's cash and cash equivalents substantially improved in fiscal 2019**

Fiscal year ending 30 June.

Source: City of Johannesburg financials

**Sophisticated financial management**

The City of Johannesburg's strong administration has implemented a number of strategies aimed at strengthening its financial management and reporting. The city achieved an unqualified audit opinion in fiscal 2019 for the seventh year in a row, indicating continued improvement in its financial management. The city's status as the country's business capital and its very large revenue base helped it achieve sound financial management and budget planning. These initiatives support our view that an increase in capital spending pressure will not cause the city's overall financial performance to deteriorate.

**Large and diversified economic base**

Johannesburg is South Africa's largest city and the country's business capital. The city is home to most of the corporate headquarters in the country. Gauteng Province, where Johannesburg is located, contributes more than one-third to the country's GDP and has a GDP per capita that is higher than the national average. Johannesburg has the largest metropolitan economy in the country, contributing about 15% of South Africa's GDP.

Johannesburg is South Africa's most populous city by a significant margin, being home to an estimated 5.3 million people in 2018, 9.0% of South Africa's population. Projections show that Johannesburg's population could increase to around 5.43 million by 2021, presenting potentially significant challenges and opportunities. In terms of population change dynamics in South African cities, Johannesburg's population growth has been the highest (96.4%) since 1996 among all South African metros. High unemployment and the infrastructure backlog pose challenges for the city's growing population. Over the past three years, the city's administration has implemented a number of strategies, such as inner city regeneration, "operation Buya Mthetho" (bring back the law) and Dipheto go (Changes), which attracted a number of businesses to help revive the city's economy, in particular within the inner city precinct. As of fiscal 2019, the city had released 154 inner city properties to private investors, with a signed lease value amounting to ZAR1.7 billion. The city expects these properties to generate investment of about ZAR32 billion on completion, create over 11,000 jobs and provide 6,500 affordable houses. The city's central location, among other factors, underpins the dominance of trade and finance in its economy.

Diversified economic sectors support Johannesburg's large economic base. Johannesburg's economy is dominated by the services sector, which is responsible for 76% of the city's economic output. The finance sector is the largest, accounting for 28% of the city's economy, while community services contribute 24% and other sectors collectively account for 48% of economic activity. The city's infrastructure is also well developed, which allows it to continue to expand its economic base. However, maintaining the existing infrastructure may

prove a challenge if Johannesburg does not realise its capital spending plans. A failure to execute capital infrastructure spending against a backdrop of high unemployment and rapid population growth will intensify the service delivery backlog and exert further spending pressure on the city.

#### **Increasing debt stock, although the debt ratio will remain relatively stable**

The City of Johannesburg accounted for about 34% of the total municipal debt in South Africa, and its outstanding bonds accounted for 37% of total municipal bonds as of the second quarter of fiscal 2018. The city recorded net direct and indirect debt/operating revenue of 37.5% in fiscal 2019, a slight decrease from 38.8% in fiscal 2018, mainly as a result of an increase in operating revenue. The city's next bond redemption of ZAR850 million is not due until March 2021. The city also manages a sinking fund for non-amortising debt, which helps ensure it has sufficient funds for maturities. Although Johannesburg's debt stock is projected to increase over the next three years in line with the city's planned borrowing of ZAR8.4 billion for the period, the expected improvement in operating revenue will offset the city's growing debt ratio.

#### **High capital spending plan**

The infrastructure backlog and rapid population growth continue to exert pressure on the city to increase capital investments. Over the next three fiscal years, 2020-22, Johannesburg plans to spend about ZAR24.3 billion on capital infrastructure. Funding for the city's planned capital investments will be relatively diversified. The City of Johannesburg will fund up to 35% of its total infrastructure investment with borrowings, while its own funds and government grants will contribute 32% and 33%, respectively.

The projected capital investments will focus on key infrastructure requirements such as electricity; water-related services; and economic development infrastructure, including social housing, roads and the public transportation system. Although its capital investments have increased substantially over the past five years, the city still faces significant challenges from its historical infrastructure backlog and rapid population growth over the past two decades.

#### **Extraordinary support considerations**

The City of Johannesburg has a low likelihood of extraordinary support from the national government, 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.

### **ESG considerations**

#### **How environmental, social and governance risks inform our credit analysis of the City of Johannesburg**

We take account of 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 Johannesburg, the materiality of ESG factors to its credit profile is as follows:

Environmental considerations are material to the City of Johannesburg's credit profile. Similar to the rest of South Africa, its main exposures relate to water shortages. Drought is the most frequent environmental constraint that directly affects the city's revenue. This challenge is managed through partnerships between the central government's department of water and the city. However, some of the financial burden of implementing and maintaining diverse water sources will be borne by the city.

Social considerations are material to 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 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 inequality rates in the world, and this also filters through to the local governments in the country, creating risks of social unrest. We also view the coronavirus outbreak as a social risk under our ESG framework, given the impact for public health and safety in the City of Johannesburg.

Governance considerations are material to the City of Johannesburg's credit profile. The city's strong administration has managed to implement prudent financial practices over the years, which have led to the city attaining an unqualified audit opinion over the past five years. Similar to those of all local governments in South Africa, Johannesburg's financial undertakings are guided by the Municipal Finance

Management Act and by the national government, through the treasury, which 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 ESG Risks](#), published in January 2019.

### Rating methodology and scorecard factors

The assigned BCA of ba1 is close to the BCA of ba2 generated by the scorecard. The matrix-generated BCA of ba2 reflects (1) an Idiosyncratic Risk score of 3 (presented below) on a scale of 1-9, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Ba1, as reflected in the sovereign bond rating for South Africa.

For details about our rating approach, please refer to the [Regional and Local Governments](#) rating methodology, published January 2018.

Exhibit 4

#### City of Johannesburg

#### [Regional and Local Governments](#)

Rating Factors						
Johannesburg, City of						
Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	1	135.60	70%	1	20%	0.20
Economic volatility	1		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	5		50%	5	20%	1.00
Financial flexibility	5		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenues (%)	3	8.89	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	7	5.13	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	3	37.50	25%			
Short-term direct debt / total direct debt (%)	1	4.30	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						<b>2.55(3)</b>
<b>Systemic Risk Assessment</b>						<b>Ba1</b>
<b>Suggested BCA</b>						<b>ba2</b>

Fiscal 2019.

Source: Moody's Investors Service

## Ratings

Exhibit 5

Category	Moody's Rating
<b>JOHANNESBURG, CITY OF</b>	
Outlook	Negative
Issuer Rating -Dom Curr	Ba1
NSR Issuer Rating	Aa1.za
Senior Unsecured -Dom Curr	Ba1
NSR Senior Unsecured	Aa1.za
ST Issuer Rating -Dom Curr	NP
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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