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INVESTORS SERVICE

CREDIT OPINION
20 June 2017

Update

Rate this Research

RATINGS

Johannesburg, City of

Domicile	Johannesburg, South Africa
Long Term Rating	Baa3
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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Johannesburg, City of

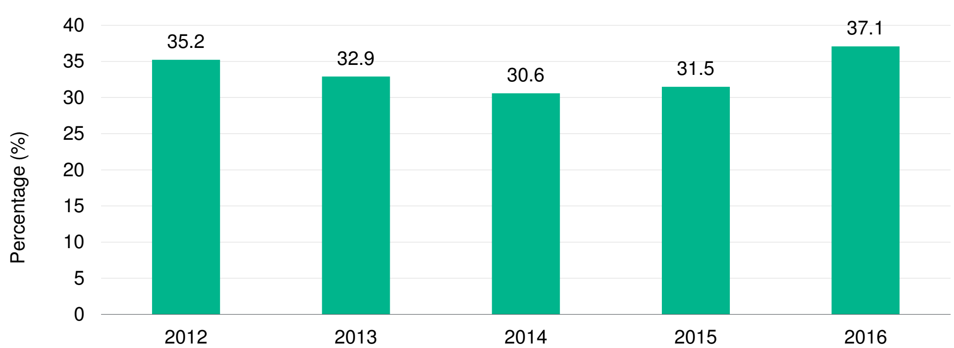
Update following sovereign action

Summary rating rationale

The City of Johannesburg's Baa3/P-3, Aa1.za/P-1.za global and national-scale issuer and debt ratings reflect the city's status as South Africa's business capital and main financial and economic centre, which allows it to access a broad tax base. The ratings also incorporate the city's consistent operating balances and improving liquidity position. We expect the debt to revenue ratio to increase moderately, despite large capital expenditure planned in the next three years. The ratings also reflect the city's high infrastructure backlogs and rapid urbanisation, which may cause it to further increase spending on capital infrastructure.

Growing debt levels, albeit manageable

Exhibit 1
Net direct and indirect debt/operating revenue (%)



Source: Moody's Investors Service

National peer comparison

We rate Johannesburg at the high end of the range of South African municipalities, whose ratings span from Aaa.za to Baa1.za. The city's relative position reflects debt and debt service levels higher than the median of rated metropolitan municipalities in the country.

Credit strengths

» Strong revenue growth supported by broad tax base

» Strong liquidity position despite high capital expenditure

» Sophisticated financial management

» Large and diversified economic base

Credit challenges

» Increasing debt levels, albeit remain manageable

» High capital expenditure plan

Rating outlook

» The negative outlook on the ratings mirrors the action taken on the ratings of the city's support provider, the Government of South Africa (Baa3 negative).

Factors that could lead to an upgrade

» An upgrade of Johannesburg's global-scale ratings would require an upgrade of the sovereign rating.

» The city's national-scale ratings would experience upward pressure independent of the sovereign impact if its liquidity position significantly improved while maintaining moderate debt levels.

Factors that could lead to a downgrade

» A weakening of South Africa's sovereign credit profile could put downward pressure on the rating.

» Financial difficulties resulting in cash flow tensions and consistently high or growing debt levels could also put downward pressure on the rating, independent of sovereign rating movements.

Key indicators

Exhibit 2
Key Indicators
Johannesburg, City of

	2012	2013	2014	2015	2016
Net direct and indirect debt/Operating revenue (%)	35.2	32.9	30.6	31.5	37.1
Interest Payments/Operating Revenue (%)	5.6	5.1	4.0	4.2	4.8
Gross Operating Balance/Operating Revenue (%)	7.7	11.6	10.9	6.2	8.0
Cash Financing Surplus (Requirement)/Total Revenue (%)	-1.7	-5.8	-3.4	-6.0	-6.0
Intergovernmental Transfer/Operating Revenue (%)	17.3	15.0	14.0	15.2	14.7
Real GDP (% change) [1]	2.7	2.6	2.1	1.4	-
GDP per capita as % of National Average	130.1	141.1	143.6	142.1	-

[1] GDP at provincial level
Source: Moody's Investors Service

Recent developments

On 12 June 2017, we downgraded by one notch the global-scale ratings of 10 South African regional and local governments, including the City of Johannesburg's Baa3/P-3 (P)Baa3 global-scale issuer and debt ratings, and changed the outlook to negative. The move reflected the close operational and financial links between municipalities and the national government, and followed the weakening of the South African government's credit profile, as captured by a similar action on the sovereign rating on 9 June 2017.

At the same time, Moody's affirmed the City of Johannesburg's national scale ratings of Aa1.za/P-1.za.

Detailed rating considerations

Johannesburg's Baa3/Aa1.za ratings combine (1) the city's baseline credit assessment (BCA) of baa3, and (2) a moderate likelihood of extraordinary support from the national government if the city faced acute liquidity stress.

Baseline credit assessment

Strong revenue growth supported by Broad tax base

Johannesburg is South Africa's largest city in terms of budget size, with total revenue of ZAR44 billion ($3.4 billion) in fiscal year (FY) 2016. The city consistently maintains strong operating balance, which was recorded at 7% of operating revenues in FY 30 June 2016 and compares well with that of other rated South African metropolitan municipalities. Despite economic challenges and low GDP growth in recent years, the city maintained robust operating revenue growth of 9% on average between 2012 and 2016.

Strong revenue growth has been driven largely by service charges, which have grown by 15% on average over the past five years, with electricity sales making the greatest contribution. The city's focus on high capital expenditure resulted in a cash financing deficit of 6% in 2016, which was largely financed through borrowing and own resources. This did not significantly affect Johannesburg's debt levels, because capital transfers and own sources financed a larger part of its capital spending.

Johannesburg is likely to continue to record a financing deficit, in line with its high capital investment plan in the next three years. Discretionary own source revenues contributed 85% of operating revenue in FY 2016, reflecting high revenue flexibility and a large and steadily growing tax base.

The improvement in Johannesburg's financial position over the past five years has been largely influenced by the city's strong cash flows and prudent expenditure management, which reduced its borrowing needs and improved the revenue collection rate. In 2012, the city announced a ZAR100 billion 10-year capital expenditure plan to address infrastructure service requirements, putting pressure on its fiscal position. However, it was able to mitigate its spending pressure by diversifying its funding sources, moderately increasing debt levels.

Strong liquidity position despite high capital expenditure

Fiscal discipline and consistent operating balances have contributed to a strong liquidity position, supported by an improvement in revenue collection rates to 95% in 2016 from 92% the previous year. Although it financed 30% of its capital infrastructure expenditure from own sources, Johannesburg recorded cash and cash equivalents of ZAR4.4 billion in 2016 (2015 ZAR4.9 billion), in line with its projections. The city will continue to fund a larger part of its capital investment from own funds, resulting in a moderate increase in debt levels.

Sophisticated financial management

Sound financial management and budget planning support our view that increased capital spending will not cause Johannesburg's overall financial performance to deteriorate. The city's investment policies are generally adequate to reduce investment risk to a low level. In the past five years, Johannesburg has improved its liquidity position and reduced its debt exposure, despite a substantial increase in capital investment. In 2016, the city received an unqualified audit opinion for the fourth year in a row, signalling a continued improvement in financial management and reporting.

Largest and diversified economic base

Johannesburg is South Africa's largest city and the country's business capital. The city is home to majority of corporate headquarters in the country and the largest listed companies. Gauteng province, where Johannesburg is located, contributes more than one-third of the country's GDP and has a GDP per capita 50% higher than the national average.

Johannesburg's population of around 4.9 million makes it the biggest metro by population size in South Africa. The city is also the country's economic and financial hub. The population grew by 11.6% between 2011 and 2016 when a national census was conducted. Projections show that Johannesburg's population could increase to around 5.43 million in 2021, presenting potentially significant threats, opportunities and challenges. High unemployment and infrastructure backlogs pose a challenge for the city's growing population. However, Johannesburg offers a business-friendly environment and has been successful in attracting business investment. 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. The finance sector is the largest employer, accounting for 26.6% of total employment, while trade, agriculture and other sectors collectively account for more than 74% of economic activity. The city's infrastructure is also well developed, allowing it to continue to expand its economic base. However, maintaining existing infrastructure may represent a challenge if Johannesburg's capital expenditure plans are not realised. A failure to execute capital infrastructure spending against a backdrop of high unemployment and rapid population growth will intensify service delivery backlogs and exert further spending pressure on the city.

Increasing debt levels albeit remain manageable

In 2016, Johannesburg's debt ratio increased to 37% of operating revenue (32% in 2015) following gross borrowing of ZAR3.9 billion. Borrowed funds were used to finance 41% of the city's ZAR9.7 billion capital expenditure plan. Although debt levels moderately increased in 2016, the city's overall debt exposure remains manageable and is still below the norm of 45% of total revenue. The city's total debt consists 44% of bonds and 56% of bank loans and other sources of funding with an average debt maturity of eleven years.

Johannesburg plans to borrow about ZAR8 billion to fund 29% of its ZAR28 billion capital expenditure plan for 2017-19. Although borrowing is projected to increase in the medium term, the city's debt ratio will remain range-bound at 35% of operating revenues in 2019, due to the city's consistent revenue growth and strong revenue collection rates.

High capital expenditure plan

In 2016 FY City of Johannesburg spent 90% of its ZAR9.7 billion capital infrastructure plan, in line with the previous year. Cash investment from own sources contributed 30% to total capital expenditure in 2016. A strong cash position helped the city fund a larger part of its capital spending from its own funds, minimising exposure to its high debt burden.

Johannesburg plans capital spending of around ZAR27 billion in 2017-19. This will be funded largely from capital transfers from the national government (37%), own resources (32%) and borrowing (29%), with contributions and donations making up the remaining 2%. The projected capital investment will focus on infrastructure requirements such as electricity, water-related services, and economic development infrastructure such as social housing, roads and the public transport system. Although capital investment has increased substantially over the past five years, the city still faces significant challenges stemming from historical infrastructure backlogs, as well the rapid urbanisation that mostly larger cities have experienced in the past two decades.

Extraordinary support considerations

The moderate likelihood of extraordinary support from the national government reflects our assessment of the government's policy stance, at the jurisdictional level, on promoting greater accountability and financial sustainability for South African municipalities. The reputation risk for the central government is modest, given the predominance of bank loans as opposed to bonds. Although the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bailout actions to avoid defaults on debt obligations. However, the government has some interest in addressing major financial problems that metropolitan municipalities could experience, given their relative importance countrywide.

Output of the baseline credit assessment scorecard

In the case of Johannesburg, the BCA matrix generates an estimated BCA of ba1, closer to the BCA of baa3 assigned by the rating committee.

The matrix-generated BCA of baa3 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Baa3, as reflected in the sovereign bond rating (Baa3 negative). The idiosyncratic risk scorecard and BCA matrix, which generate estimated BCAs from a set of qualitative and quantitative credit metrics, are tools that the rating committee uses in assessing regional and local government credit quality.

The credit metrics that these tools capture provide a good statistical gauge of standalone credit strength. Higher ratings are generally likely among issuers with the highest scorecard estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual BCAs, and the scorecard is not a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables that these tools include cannot fully capture the breadth and depth of our credit analysis.

Rating methodology and scorecard factors

Exhibit 3

Rating Factors						
Johannesburg, City of						
Baseline Credit Assessment	**Score**	**Value**	**Sub-factor Weighting**	**Sub-factor Total**	**Factor Weighting**	**Total**
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	1	147.83	70%	1	20%	0.20
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	5	20%	1.00
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	8.13	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	5	4.51	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	3	37.10	25%			
Short-term direct debt / total direct debt (%)	1	3.30	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.48(2)
Systemic Risk Assessment						Baa3
Suggested BCA						ba1

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
JOHANNESBURG, CITY OF	
Outlook	Negative
Issuer Rating -Dom Curr	Baa3
NSR Issuer Rating	Aa1.za
Senior Unsecured -Dom Curr	Baa3
NSR Senior Unsecured	Aa1.za
ST Issuer Rating -Dom Curr	P-3
NSR ST Issuer Rating	P-1.za

Source: Moody's Investors Service

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