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CREDIT OPINION
30 September 2020

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RATINGS

Zagrebacki Holding D.O.O.

Domicile	Zagreb, Croatia
Long Term Rating	Ba2
Type	LT Issuer Rating - Fgn Curr
Outlook	Positive

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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Zagrebacki Holding D.O.O. (Croatia)

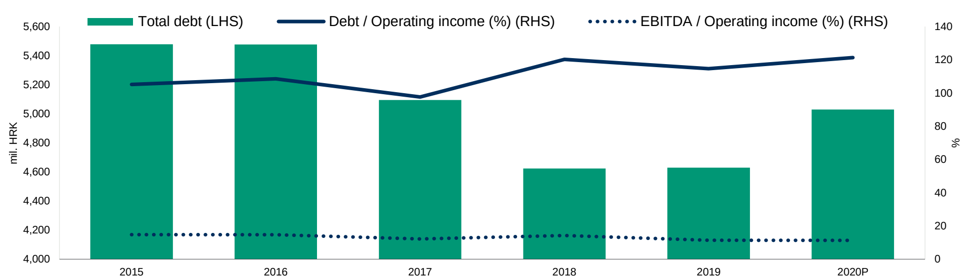
Update to credit analysis

Summary

The credit profile of Zagrebacki Holding D.O.O. (Holding, Ba2 positive) is underpinned by its strong financial and institutional links with its sole shareholder the City of Zagreb (Ba2 positive), given its strategic role in executing the city's statutory services as well as our assessment of a very high likelihood of the City of Zagreb providing timely support should the entity face acute liquidity stress. The rating also reflects the favourable regulatory framework, which ensures the stability and predictability of future revenue streams in Holding's core business.

The unprecedented shock caused by the coronavirus pandemic and the decline in Holding's operations will affect the company's income in 2020. Holding's credit profile remains constrained by its sizeable debt burden, although half of it is guaranteed by the City of Zagreb.

Exhibit 1
Stable financial performance, although debt burden remains high



P - projection.
Source: Moody's Public Sector Europe, Zagrebacki Holding

Credit strengths

» Strong institutional and financial links with the City of Zagreb

» Supportive regulatory and financial framework, which ensures predictable cash flow

» Solid financial performance, although expected to weaken moderately in the short term

Credit challenges

» Debt burden remains sizeable

Rating outlook

The positive outlook on Holding's rating mirrors that on the rating of its support provider, the City of Zagreb. It also reflects our expectation that the Holding will maintain its strong institutional, economic and financial links with the City of Zagreb.

Factors that could lead to an upgrade

» An upgrade of Holding's rating would result from a similar action on the City of Zagreb's rating, given their close financial and operational links.

Factors that could lead to a downgrade

» Although unlikely, given the positive outlook, a downgrade of Holding's rating would result from a downgrade of the City of Zagreb's rating.

» Negative changes in the institutional and financial framework under which Holding operates could also exert downward pressure on the company's rating.

Key indicators

Exhibit 2

Zagrebacki Holding

(as of 31. December)	2015	2016	2017	2018	2019	2020P
Total Debt / Operating Income (%)	105%	109%	98%	120%	115%	121%
EBITDA / Operating Income (%)	15%	15%	12%	14%	11%	11%
Net Income/ Operating Income (%)	2%	1%	0%	2%	0%	0%
Total Debt to EBITDA (x)	7x	7x	8x	9x	10x	11x
Total Debt / Total Assets (%)	27%	27%	26%	28%	28%	30%
Total Assets (mil. HRK)	20,536	20,058	19,463	16,314	16,485	16,762

P - projection.
Source: Moody's Public Sector Europe, Zagrebacki Holding

Detailed credit considerations

Moody's Public Sector Europe considers Zagrebacki Holding a government-related issuer. Holding's credit strength is inextricably linked with that of the City of Zagreb because of its clear public policy mandate and key role in the city's utilities sector. As such, its rating is derived primarily from the credit strength of the City of Zagreb without assigning a Baseline Credit Assessment, as described in our Government-Related Issuers rating methodology, published in June 2018. From a credit risk perspective, there is no meaningful distinction between the Holding and the City of Zagreb because of the intrinsic operational ties between the two entities.

Baseline Credit Assessment

Strong institutional and financial links with the City of Zagreb

Zagrebacki Holding is a legal corporation with limited liability, established by the City of Zagreb, which is Croatia's capital and largest city, and currently comprises 14 branches and holds majority stakes in nine subsidiary companies, each of which performs a different function. The institutional framework under which Holding operates is mostly defined by the city's decisions, with the sole exception of the gas business, which is regulated at the central government level.

Holding's strong ties with its owner are also reflected in its governance. Zagreb exercises strong control and oversight on Holding's strategies, business plan, investment programme and borrowing plan. Holding's assembly, which comprises the mayor of Zagreb, deputy mayor and the mayor's advisor, appoints the management board.

After the demerger of its public transport company Zagreb Electric Tram (ZET) in 2018, Holding no longer receives operational subsidies from the city. However, Holding benefits from the city's guarantee on half (HRK2.3 billion) of its total debt (HRK4.6 billion) as of year-end 2019 compared with 10% in 2015. The increase is because of a new unconditional guarantee provided by the city on a bond issue to refinance the euro bond, which is due in July 2023. As such, the City of Zagreb confirms the recognition of the holding company's debt as the city's obligation.

Our assessment of Holding's public mandate and its integration with the city's institutions supports the very high likelihood of receiving extraordinary support from the City of Zagreb. The very high default dependence between the Holding and the City of Zagreb reflects the fact that Holding generates its revenue from the areas within the city and is, therefore, exposed to business cycle fluctuations that might also influence the city's fiscal situation.

Taking into account the nature of Holding's core businesses and the city's long-term track record of supporting the company in maintaining its strategic assets, we believe that the City of Zagreb will continue to be supportive of the company.

Predictable regulatory and financial framework, which ensures regular cash flow

Zagrebacki Holding is a key component of the City of Zagreb's development strategy. The company has a quasi-monopolistic position in all key businesses of the City of Zagreb. The city's well-diversified local economy supports demand for Holding's services.

Holding's four major businesses comprise (1) water supply and sewage, (2) gas supply, (3) waste collection and recycling, and (4) maintenance and cleaning of public roads. Together, they accounted for 64% of Holding's income in 2019, of which the gas and water utilities account for 45%. In 2019, all major business lines were profitable except waste collection and recycling following the costs associated with investments in waste management to comply with the recent changes in the national legislation. In addition, the suspension of the new Decree on waste management by the Constitutional Court had negative effects on the operations of this segment, which resulted in combined losses of HRK135.5 million in 2019. However, these businesses can only record a very limited profit margin, given the strict tariff regulations.

The City of Zagreb regulates tariffs for key businesses in Holding, with the exception of the gas company, whose tariffs are regulated at the national level. Although the city generally provides beneficial regulations for these businesses, tariffs typically cover Holding's operating costs and capital spending, as well as the cost of external financing. Most of the company's business is likely to remain regulated and it should maintain its dominance in key business lines. Overall, tariff regulation remains a socially and politically sensitive instrument as Holding's services should be affordable.

Holding's revenue and expenditure structure is well established and, in our opinion, prospects are limited for any shift in its business model that could affect its revenue dynamics. Holding's monopolistic status as the sole provider of a city's statutory services is also unlikely to change in the medium term.

Solid financial performance, although expected to weaken moderately in the short term

Despite the negative implication of the regulatory changes on the gas business and increased costs in the cleaning and waste segment to comply with the new regulation on waste management, Holding posted a net income of HRK14.3 million, representing 0.4% of its operating income in 2019. It marks Holding's seventh consecutive year of positive financing results.

Holding's operating income increased by 6% to HRK4.088 million in 2019, largely because of higher income from construction and project management segment (HRK91 million), gas distribution (HRK42 million), water supply (HRK20 million) and parking (HRK20 million).

The deterioration in Holding's EBIT/operating revenue ratio to 1.8% in 2019 from 4.2% in 2018 mirrors the weakening of net income. The EBIDTA margin also deteriorated to 11.4% from 13.9% over the same period, as the increased company's spending of 9% surpassed operating income growth. Moreover, the costs increase was attributable to higher costs for materials and services (HRK223 million) and staff (HRK90 million). We expect the EBITDA margin to remain at similar levels in 2020, although the continued pressure on gas supply and higher projected staff costs for the cleaning and waste management segment have the potential to strain the margin.

In 2020, despite the negative effects of coronavirus pandemic, we expect Holding to post balanced financial results following the projected decline of investments estimated at HRK323 million. During 2021-22, Holding will continue to control its investments and further scale down capital expenditures averaging HRK197.5 million per year.

In addition, the collective agreement signed with the labor union in December 2019 has the potential to additionally weaken the operating performance of the company as the agreement includes a 5.8% salary increase and non-taxable benefits estimated at HRK60 million.

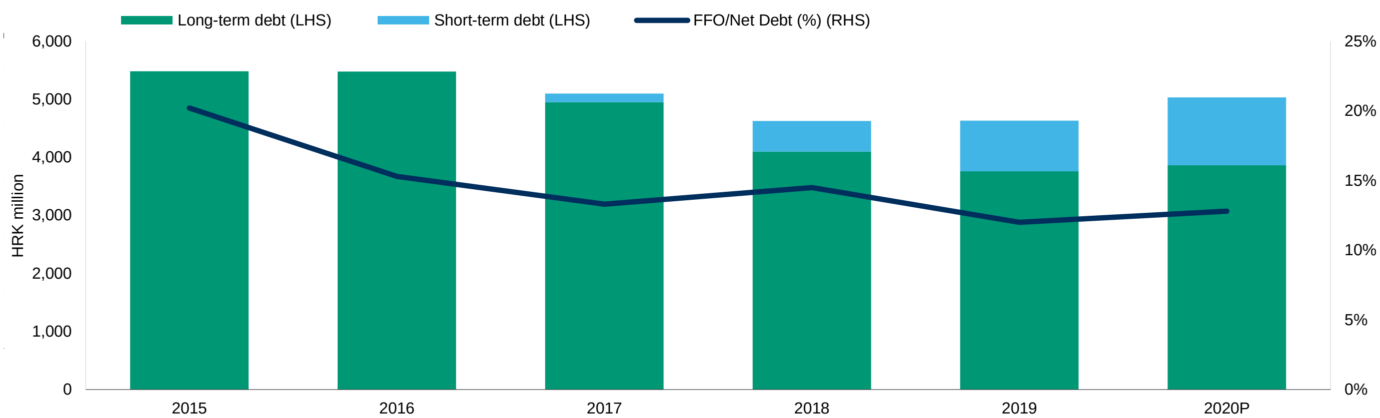
Overall, the company's liquidity, consisting of short-term deposits and available credit facilities, totalled HRK233 million as of year-end 2019, representing low 6.4% of operating expenses compared with 18.9% in 2018. We expect Holding's liquidity position to remain low but regular cash flow will ensure sufficient funds for debt servicing costs of HRK787 million projected for 2020 including roll-over of short term loans.

Debt burden remains sizeable

Holding's debt has stabilized at HRK4.6 billion in 2019 and is projected to increase to HRK5 billion in 2020. However, its debt burden remained high with debt/EBITDA at 10x compared with 8.7x in 2018. The short term debt increased in 2019 representing 18.9% of total debt up from 11.4% in 2018 and the business plan for 2020 indicates that this ratio will remain at around 20%.

Exhibit 3

Increasing portion of short term debt; FFO as % of net financial position remain stable



P - projection.

Source: Moody's Public Sector Europe, Zagrebacki Holding

From 2021 onwards, Holding will focus on other sources for investment funding, including the European Union funds and the support from the city and central government institutions. Holding's debt consists of bank loans (35%), local currency-denominated bonds (50%) and financial leases (15%). Holding's repayment schedule is characterised by amortising bank loans and leases, as well as a local-currency bond with bullet maturity.

The replacement of the euro-denominated bond with a local-currency issue in 2017 reduced Holding's foreign-currency exposure to 22% of total debt as of year-end 2019 from below 50% in 2016. Interest rate risk is low as a high 88% of Holding's debt carry fixed rate.

Environmental, social and governance considerations

How environmental, social and governance risks inform our credit analysis of Zagrebacki Holding

Moody's takes into account the impact of environmental, social and governance factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Zagrebacki Holding, the materiality of environmental, social and governance considerations to its credit profile are as follows:

Environmental considerations are not material to Zagrebacki Holding's credit profile. Its main environmental risk exposures relate to earthquakes. However, as evidenced during the earthquake in March this year, the national government bears most of the costs of reconstruction at the local level. In line with the rest of Croatia, another environmental risk exposures relate to water shortage and flood risk. Flood risk is managed by the city and national authorities, and therefore, the financial burden of adapting to increased flood risk will not fall on Zagrebacki Holding.

Social considerations are material to Zagrebacki Holding's credit profile. We view the coronavirus pandemic as a social risk under our ESG framework, given the substantial implications for public health and safety. However, we expect the pandemic to weaken the public service provision in Croatia, but also Holding to be able to mitigate the weakness so that its credit profile is not materially affected. The sector is moderately exposed to risks stemming from socially driven policy agendas, and is also affected by the impact of demographic trends and customer relationships on demand.

Governance considerations are material to Zagrebacki Holding's credit profile. Although evolving, Holding's management and governance are well established, with policies and practices that are aligned to its business plan and development strategy. Holding also benefits from a strong regulatory framework and close oversight by the city and national regulatory body.

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.

Rating methodology and scorecard factors

The principal methodology used in the rating of this entity is the Government-Related Issuers rating methodology, published in June 2018.

Ratings

Exhibit 4

Category	Moody's Rating
ZAGREBACKI HOLDING D.O.O.	
Outlook	Positive
Issuer Rating	Ba2

Source: Moody's Investors Service

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