

Research Update:

# Croatian Diversified Utility Company Zagrebacki Holding Upgraded To 'B+' On Bond Refinancing; Outlook Positive

July 12, 2023

## Rating Action Overview

- On July 11, 2023, Zagrebacki Holding (ZGH) issued a €305 million bond due in July 2028 to refinance its Croatian kuna (HRK) 2.30 billion (about €305 million) bond due on July 15, 2023.
- This marks the third milestone achieved by the company's new management after refinancing short-term loans with long-term loans in 2022 and generating positive reported EBITDA of about €77 million in 2022, after two years of losses.
- We consider ZGH's stand-alone credit profile (SACP) has improved to 'ccc+' from 'ccc' and still see a very high likelihood of the company receiving support from its owner, the city of Zagreb, leading to a three-notch rating uplift.
- As a result, we have raised our long-term issuer credit rating on ZGH to 'B+' from 'B'.
- The positive outlook mirrors that on Zagreb, indicating that we could upgrade ZGH if we were to upgrade the city and ZGH delivers on its strategic plan, notably with EBITDA remaining in positive territory over 2023-2024, leading us to revise our SACP assessment to 'b-'.

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## Rating Action Rationale

**ZGH's full-year results show successful delivery of management's goals for 2022, improving our view of the company's ability to execute on planned strategy.** The new management team, established in 2021, had three main goals by midyear 2023, including: (1) refinancing of the short-term loan portfolio into long-term debt, (2) ensuring EBITDA of HRK500 million (about €66 million) by the end of 2022, and (3) refinancing the €305 million bond maturing in July 2023.

- Regarding the first goal, ZGH refinanced HRK1.55 billion of its HRK1.96 billion loan portfolio in September 2022, using part of the proceeds from a €240 million loan. The new €240 million loan, which is in three tranches, has an average tenor of 10 years with a one-year grace period and an average coupon of 4.8%. This transaction improved the company's liquidity structure, since ZGH no longer needs to rely on refinancing short-term lines every year to operate. From

2024, ZGH's loan amortization will total €20 million–€23 million.

- Second, at year-end 2022, ZGH reported EBITDA of €77 million, exceeding its goal of about €66 million as well as our forecasts. The improvement stemmed from cost-efficiency measures, mergers of subsidiaries, and an increase in waste tariffs. We believe ZGH's business optimization efforts will continue over the next few years, contributing to reported EBITDA increasing to €80 million–€85 million (or S&P Global Ratings-adjusted EBITDA of about €60 million). Combined with reported debt of €600 million, we expect ZGH to achieve its target of reported leverage below 9.5x (equivalent to our adjusted 11x metric) over the next few years.
- Third, the HRK2.30 billion (about €305 million) 3.9% bond due on July 15, 2023, will be fully repaid using the proceeds of ZGH's €305 million 4.9% bond issued on July 11, which has an unconditional and irrevocable guarantee from the city of Zagreb.

**We foresee an improvement in ZGH's liquidity following the recent refinancing of the HRK2.30 billion bond due in 2023.** The new bond of €305 million, which is fully guaranteed by the city of Zagreb, represents about 50% of the company's total financial debt. We therefore no longer see a risk of near-term liquidity stress and expect liquidity sources to comfortably cover uses over the next 12 and 24 months. Nevertheless, the timing of the issuance, so close to the due date, prevents us from regarding liquidity as stronger than less than adequate until we see a track record of successful liquidity management. We also view as positive the strong coupon rate of 4.9% on the new bond in the high-interest-rate environment.

**We continue to see a very high likelihood that the city of Zagreb would support ZGH in the event of distress, which results in three notches of uplift from the SACP.** We see ZGH as the government's vehicle to implement its policies for the city of Zagreb. The company benefits from its long-term contractual relationship with the city, which protects its near monopoly in providing essential public services and infrastructure to the population of Zagreb. ZGH's operations range from gas distribution and supply, water treatment and supply, waste collection and treatment, as well as city cemeteries, pharmacies, markets, outdoor advertisements, and municipal housing. We also believe the city's full ownership of ZGH, and its involvement in defining and establishing the company's strategy, investment plan, and budget, emphasize the very strong link between ZGH and the city. This was recently demonstrated by the city's willingness to fully guarantee ZGH's bond issuance. We therefore continue to believe that, despite liquidity constraints at the city, in the event of distress, the city would be willing to support ZGH in a timely manner. This is because a default of the company would hurt the new city administration's reputation.

## Outlook

The positive outlook mirrors that on the city of Zagreb. We expect that ZGH will continue to optimize its operations and its related costs to ensure stable reported EBITDA of €65 million–€80 million over the next two years.

## Downside scenario

A negative rating action on the city of Zagreb would trigger a similar action on ZGH. Separately, weakening of ZGH's SACP to 'ccc' would also trigger a downgrade of ZGH.

## Upside scenario

An upgrade to 'BB-' could follow if we were to upgrade the city and ZGH continues delivering on its strategy, notably with EBITDA remaining positive over 2023-2024, leading us to revise our assessment of its SACP to 'b-'.

## Company Description

ZGH is a diversified utility company, created in 2005 to streamline control over 20 municipal companies in Zagreb and raise external funding for the city's municipal investment program. ZGH is 100% owned by Zagreb and is the largest corporate employer in Croatia.

The group includes 13 branches, six 100%-owned affiliates, and one 51%-owned affiliate. These divisions and subsidiaries have quasi monopolistic positions in providing essential municipal services, such as gas distribution and supply, water supply and sewerage, road maintenance, waste disposal, and real estate projects. In 2022, ZGH reported EBITDA of €77 million and debt of €600 million.

## Liquidity

We assess ZGH's liquidity as less than adequate, since its sources are expected to cover its uses by more than 1.0x over the 12 months started June 30, 2023. In our view, the company has strong access to domestic bank funding, as shown by the relatively recent refinancing of its entire loan portfolio, agreements to extend credit lines during periods of stress, and refinancing of the bond due in July. Access to funding should improve further, since Croatia entered the eurozone in January 2023.

Principal liquidity sources over the next 12 months:

- Available cash of about €90 million;
- No available undrawn long-term committed bank lines;
- Forecast funds from operations of €30 million-€40 million; and
- Proceeds from the new €305 million 4.9% bond maturing on July 11, 2028.

Principal liquidity uses over the same period:

- Debt maturities of €318 million, of which €305 million relates to the HRK2.30 billion bond due on July 15, 2023;
- €30 million-€50 million of capital expenditure; and
- No dividend payments.

## Environmental, Social, And Governance

### ESG credit indicators: To E-2, S-2, G-4; From E-2, S-2, G-5

We now view governance as a negative factor in our credit rating analysis of ZGH. Since 2022,

ZGH's new management has been working on a restructuring strategy to fully reshape the company and we already see some positive results. The company however continues to show difficulties in centralizing information from its multiple segments, which we see as weighing on governance. ZGH is a government vehicle to implement the city of Zagreb's strategies and it operates throughout several branches, including gas distribution and supply, waste collection and treatment, water supply, cemeteries, publishing, city markets, and many others.

## Ratings Score Snapshot

Issuer Credit Rating	B+/Positive
Business risk:	Weak
Country risk	Moderately high
Industry risk	Intermediate
Competitive position	Weak
Financial risk:	Highly leveraged
Cash flow/leverage	Highly leveraged (Standard Volatility Table)
Anchor	b-
Modifiers:	
Diversification/Portfolio effect	Neutral
Capital structure	Neutral
Financial policy	Neutral
Liquidity	Less than Adequate
Management and governance	Fair
Comparable rating analysis	Neutral
Stand-alone credit profile:	ccc+
Related government rating	BB
Likelihood of government support	Very high (+3 notches)

## Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings , Oct. 10, 2021
- General Criteria: Group Rating Methodology , July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments , April 1, 2019
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions , March 25, 2015
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers , Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry , March 28, 2014
- Criteria | Corporates | General: Corporate Methodology , Nov. 19, 2013

- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry , Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions , Nov. 19, 2013
- General Criteria: Methodology: Industry Risk , Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities , Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings , Feb. 16, 2011
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating , Oct. 1, 2010

**Related Research**

- Industry Credit Outlook: EMEA Utilities 2023 Outlook: Eastern Europe: Credit Resilience Despite Increasing Affordability Concerns, Jan. 12, 2023
- Eastern European Utilities Handbook 2023, Jan. 5, 2023
- Western Europe Regulated Gas Utilities Handbook 2022, Nov. 4, 2022

**Ratings List**

**Upgraded**

	To	From
<b>Zagrebacki Holding d.o.o.</b>		
Issuer Credit Rating	B+/Positive/--	B/Stable/--

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