

Research Update:

# **DRAFT: Croatia-Based Zagrebacki Holding 'B+' Rating On Watch Negative On Tightening Liquidity**

March 31, 2020

## Rating Action Overview

- We believe that the COVID-19 pandemic and recent earthquakes are limiting the City of Zagreb's ability to support Zagrebacki Holding in a timely manner, and pressuring Zagrebacki Holding's liquidity and operations.
- On March 27, 2020, we revised our outlook on the 'BB' rating on the City of Zagreb to negative from stable.
- We are therefore placing our 'B+' rating on Zagrebacki on CreditWatch with negative implications.
- The CreditWatch negative reflects the uncertainty regarding the city's ability to provide timely support to the holding, as well as potential pressures on its liquidity in the near term, which could result in a downgrade.

## Rating Action Rationale

**The recent earthquake and COVID-19 pandemic will likely limit Zagreb's ability to provide timely support to Zagrebacki.** Zagrebacki's credit quality is closely linked to that of its 100% shareholder, the city of Zagreb. On March 27, we revised the outlook on the city to negative, because the combined effects of the COVID-19 outbreak and recent earthquake could considerably worsen the city's financial situation, while support mechanisms from Croatia's federal government and the EU are yet to be worked out (see "City of Zagreb Outlook Revised To Negative From Stable On Deteriorating Financial Situation; 'BB' Ratings Affirmed").

We see the risk that Zagreb's ability to provide timely support to Zagrebacki, as well as the city's policy priorities amid new challenges, could change in the current environment.

Currently, our rating on Zagrebacki includes a two-notch uplift reflecting our expectation of very high likelihood of government support. Zagrebacki provides Zagreb with all the essential infrastructure (waste removal and treatment, gas distribution and supply, water treatment and supply, and parking spaces), and is therefore key to Zagreb's strategy and projects implementation. In addition, the links between Zagrebacki Holding and Zagreb are very strong.

### PRIMARY CREDIT ANALYST

**Renata Gottliebova**  
Dublin  
+353 1 568 0608  
renata.gottliebova  
@spglobal.com

### SECONDARY CONTACT

**Elena Anankina, CFA**  
Moscow  
(7) 495-783-4130  
elena.anankina  
@spglobal.com

### RESEARCH CONTRIBUTOR

**Emeline Vinot**  
Paris  
(33) 1-4075-2569  
emeline.vinot  
@spglobal.com

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The city owns 100% of Zagrebacki, approves the group's investment plans, and guarantees the group's long-term debt, even if it doesn't intervene in ZGH's day-to-day business. Still, we note that the holding's activities would likely continue even in a stress-scenario debt restructuring.

**Zagrebacki's liquidity and operations could come under additional pressure.** We believe that the COVID-19 pandemic and the recent earthquakes could further pressure Zagrebacki's liquidity and leverage, but the impact is yet to be assessed. The company's leverage is already high (expected around 10x at the end of 2019) and it has sizable short-term debt, resulting in our stand-alone credit profile of 'b-'. Although Zagrebacki traditionally has good relationships with local banks and has been able to roll over its short-term debt under normal historical conditions, the sustainability of its liquidity arrangements will be tested in the currently challenging operating and financial environment.

We now expect lower cash flows in 2020 than we had previously forecast, slightly offset by a reduction in capital expenditure. Zagrebacki stopped non-essential operations (parking, markets, bus transportation and so on) solely focusing on gas distribution and supply as well as water and waste treatment and road works. Meanwhile, some of the holding's labor force may not be available to repair assets affected by the earthquake because of social distancing requirements, but we understand from the company that around 80% of employees are still doing their job. We do not rule out working capital outlays if customers' payments are delayed.

It remains to be seen whether the city's support will offset pressures on Zagrebacki's liquidity.

## CreditWatch

The CreditWatch reflects the potential for a downgrade stemming from a combination of three main factors:

- Potential deterioration in Zagreb's credit quality.
- A potential change in government if the city's policy priorities shift amid COVID-19 and the recent earthquake. We recognize the essential nature of Zagrebacki's operations for the city, but we believe that its operations could continue even if the company has to restructure its debt--which may reduce the government's incentives to provide timely support.
- Ongoing pressures on Zagrebacki's liquidity and stand-alone credit quality.

If we lower our rating on Zagreb by one notch, we would lower our rating on Zagrebacki by at least one notch. If combined, negative developments in several of the above areas could lead to a multi-notch downgrade.

We aim to resolve the CreditWatch within 90 days, and will monitor the company's and city's plans to cope with mounting adversities.

## Liquidity

We currently assess Zagrebacki's liquidity as less than adequate. Its ratio of committed liquidity sources to uses is only about 0.7x in 2020. Historically, the holding has been able to roll over short-term bank lines from domestic banks every year and we believe this will likely continue. Also, we believe it has some capital expenditure (capex) flexibility.

The principal liquidity sources for the 12 months from Dec. 31, 2019 are:

- Balance sheet cash of about HRK250 million;

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- No available long-term committed bank lines; and
- HRK380 million in cash flow from operations.

We expect the following principal liquidity uses for the same period:

- Short-term debt maturities of approximately HRK390 million;
- Capex of around HRK320 million; and
- No dividend payments.

### Ratings Score Snapshot

Issuer Credit Rating: B+/Watch Neg/--

Business risk: Weak

- Country risk: Moderately high
- Industry risk: Low risk
- Competitive position: Weak

Financial risk: Highly leveraged

- Cash flow/leverage: Highly leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral/Undiversified (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Less than adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1 notch)

Stand-alone credit profile: b-

Related government rating: BB

Likelihood of government support: Very high (+2 notches from SACP)

### Related Criteria

- 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

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Corporate Issuers, Dec. 16, 2014

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## Ratings List

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceld/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceld/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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