Research Update:

Croatia-Based Zagrebacki Holding Rating Lowered To 'B-' From 'B+' Following Downgrade Of City Of Zagreb; Outlook Stable

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Rating Action Overview

- On Sept. 25, 2020, we downgraded the City of Zagreb, sole owner of Zagrebacki Holding d.o.o (ZGH), to 'BB-' from 'BB'.
- We believe that, although Zagreb will continue to support ZGH, its ability to do so has diminished as a result of COVID-19-related shortfalls in tax revenue and additional reconstruction costs following the March earthquakes.
- We are therefore lowering our long-term issuer credit on ZGH to 'B-' from 'B+'.
- The stable outlook reflects our expectation Zagreb's willingness to provide extraordinary support to ZGH will remain very high, and that ZGH will maintain its liquidity position and continue rolling over short-term debt.

Rating Action Rationale

The City of Zagreb's ability to support ZHG has diminished significantly. This is a consequence of the city's COVID-19-related shortfalls in tax revenue and additional reconstruction costs following the March earthquakes. Furthermore, we consider Zagreb's liquidity as weak given the little cash available and limited access to capital markets. For more information see "City of Zagreb Downgraded To 'BB-' On Reconstruction Costs; Outlook Negative," published on Sept. 25, 2020, on RatingsDirect.

The COVID-19 pandemic and consequences of the March earthquake continue to put pressure on ZGH's stand-alone credit quality, but we expect metrics will gradually recover. We forecast S&P Global Ratings-adjusted EBITDA of about Croatian kuna (HRK) 165 million in 2020, down from HRK401 million in 2019, translating into funds from operations (FFO) to debt of 0.7%, down from 7.5% in 2019. However, we expect ZGH's EBITDA will recover to 2019 levels by 2021, with S&P Global Ratings-adjusted FFO to debt reaching 5%-10% thanks to stabilizing operating conditions, gas supply market liberalization, and proposed waste tariff increases. We continue to assess ZGH's stand-alone credit profile (SACP) at 'ccc+', reflecting its weak stand-alone metrics and liquidity.

ZGH's liquidity remains weak, but we expect no further deterioration. In line with its previous behavior, ZGH continues to rely on short-term bank debt, and we understand that long-term bank lines may not be available in Croatia. Still, the company demonstrates sound relationships with domestic banks, and has managed to extend all of its short-term rolling credit lines despite the difficult market conditions. Its HRK70 million short-term loan maturing in December 2020 is currently being refinanced through a long-term loan contracted by ZGH's water business.

Our base-case scenario for ZGH assumes no new debt moratoriums. In summer 2020, the company used an opportunity provided by the Croatian government to extend principal payments under long-term bank facilities by three months. Given the three months are up, payments of both principal and interests have resumed as normal, and we understand that the government/regulator has provided adequate compensation to the banks during this three-month period. Should ZGH take advantage of any further government moratoriums, we will assess whether compensation to banks over the extended period is adequate and if the company's move to delay payments is opportunistic or distressed.

ZGH's credit quality continues to be underpinned by our expectation of support from Zagreb. Zagreb fully owns ZGH, guarantees both the company's HRK2.3 billion bond and its long-term debt, and significantly influences key strategic decisions. ZGH implements the city's strategies through its quasi-monopolistic activities in critical infrastructure services, which include gas distribution and supply, water treatment, water supply, waste recycling, and parking provision. However, the city doesn't intervene in day-to-day business. In early September, the Croatian parliament decided that Zagreb would have to cover 20% of the significant reconstruction costs following the March earthquake. We can't rule out the possibility that ZGH will have to cover some of these costs, given their magnitude, which would lead to a debt increase. However, this scenario in not part of our base case. Nevertheless, given this possibility, we continue to assume that ZGH will be able to rely on the city's support in negotiations with the banks, helping them extend credit lines and guaranteeing long-term loans as in the past.

Outlook

The stable outlook reflects our expectation that ZGH will maintain its liquidity position, continue to roll over short-term debt, and won't take advantage of any further debt moratoriums. We also expect no significant changes to the group structure, the city's policy to support the company, or ZGH's stable operating performance. We forecast FFO to debt of 5%-10% in 2021 and no material debt increases.

Downside scenario

We could lower the ratings if ZGH's liquidity weakens significantly, for example if the company can't extend its bank lines or enters into debt restructuring that we would view as distressed.

We could also downgrade ZGH if we lower our ratings on Zagreb by more than two notches, but this is not our base-case scenario. A one-notch downgrade of Zagreb wouldn't affect our current rating on ZGH.

Upside scenario

We see ratings upside as limited at this time. We would upgrade ZGH if we see significant improvement in its liquidity, with no deficit in a twelve month period and reduced reliance on short-term debt. We would also expect better credit metrics on the back of a stronger operating performance thanks to increased waste tariffs and the renegotiation of short-term loans to long-term loans. This is not our base case for the next 12-18 months, however.

We could also raise the ratings if we took a similar action on the City of Zagreb.

Company Description

ZGH is a diversified multi-utility created in 2005 to streamline control over 23 existing municipal companies and raise external funding for the municipal investment program. ZGH is 100% owned by Zagreb and is the largest corporate employer in Croatia, with about 7,800 employees as of Dec. 31, 2019.

The group includes 14 branches, eight 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. As of December 2019, the group served about 1.1 million users within Zagreb County. Of the group's 23 companies, the gas distribution and supply, the water treatment division and the waste divisions represented about 55% of 2019 revenue and EBITDA.

Our Base-Case Scenario

In our base-case scenario, we assume the following:

- Real GDP in Croatia to shrink by 9.0% in 2020, and then increase by 5.3% in 2021 and 2.5% in 2022. There is no direct link with operating performance.
- We forecast total capital expenditure (capex) at HRK1.3 billion over 2019-2021. The main investments are HRK500 million a year at the holding level (including the city's waste businesses), and about HRK130 million in the water business. About HRK100 million is spent annually on the grid business for maintenance and replacement purposes. We do not include a potentially large investment in a new sewage and waste-water treatment plant, because it would occur only if ZGH secures EU funding and therefore remains highly uncertain at this stage.
- We anticipate a recovery in the waste segment once new pricing tariffs come in, which is expected in 2021.
- We don't anticipate a recovery in the gas sector, despite the switch to a fixed and variable tariff from a variable tariff because of the low tariffs for the current regulatory period (2018-2021) for gas distribution system operators.
- Corporate income tax of 18% over the 2020-2023 period.
- No dividends.
- No additional debt as a result of Zagreb's reconstruction costs.

Based on these assumptions, we arrive at the following credit measures:

- Debt to EBITDA of about 30x in 2020, falling to about 14x in 2021, and expected to recover to 2019 levels by 2022-2023;
- FFO to debt of 0.7% in 2020, slowly recovering 2019 levels by 2023;
- Broadly stable debt of about HRK5.3 billion; and
- Sustainably negative free operating cash flows from 2020.

Liquidity

We assess ZGH's liquidity as weak because its sources will exceed its uses by less than 1.2x within the next 12 months from Aug. 31, 2020.

In our view, the company still has access to domestic bank funding, demonstrated by annual refinancing of short-term credit lines and agreements to extend credit lines in periods of stress.

We understand that management is pushing financial institutions to commit to providing ZGH with long-term credit lines. This would ultimately be positive for our liquidity assessment.

The principal liquidity sources for the 12 months starting Aug. 31, 2020:

- Balance sheet cash of about HRK 160 million;
- No available long-term committed bank lines; and
- Forecast HRK230 million in cash flow from operations.

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

- Short-term debt maturities of approximately HRK280 million;
- Capex of about HRK320 million; and
- No dividend payments.

Government Influence

The rating on ZGH incorporates one notch of uplift from the its SACP of 'ccc+'. This is based on our view of a very high likelihood that Zagreb will provide sufficient and timely extraordinary support to ZGH if needed. This reflects our assessment of the group's:

- Very important role for Zagreb given it provides the city essential municipal services such as gas supply and distribution, water supply and sewerage, road maintenance, waste disposal, and real estate projects.

Very strong link with the city, given Zagreb's strong involvement in ZGH's business strategy and budget approval, and its track record of providing support to ZGH to improve liquidity, notably through guarantees on financial debt issuance and facilitating loans. The city has also previously helped ZGH turn its short-term debt into long-term debt.

Ratings Score Snapshot

Issuer Credit Rating: B-/Stable/--

Business risk: Weak

- Country risk: Moderately High
- Industry risk: Intermediate
- Competitive position: Weak

Financial risk: Highly Leveraged

- Cash flow/Leverage: Highly Leveraged

Anchor: b

Modifiers

- Diversification/Portfolio effect: Neutral
- Capital structure: Neutral
- Liquidity: Weak (-1 notch)
- Financial policy: Neutral
- Management and governance: Fair
- Comparable rating analysis: Negative(-1 notch)

Stand-alone credit profile: ccc+

- Sovereign rating: BB-/Negative
- Likelihood of government support: Very High (+1 notch)

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 Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- Criteria | Corporates | Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating, Oct. 1, 2010

Ratings List

Downgraded

	To	From
Zagrebacki Holding d.o.o.		
Issuer Credit Rating	B-/Stable/--	B+/Negative/--