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## Research Update:

# Croatia-Based Multi-Utility Zagrebacki Holding Upgraded To 'B+' On Improved Liquidity; Outlook Stable

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## Research Update:

# Croatia-Based Multi-Utility Zagrebacki Holding Upgraded To 'B+' On Improved Liquidity; Outlook Stable

## Overview

- We think that Zagrebacki Holding (ZGH), a multi-utility conglomerate 100%-owned by the city of Zagreb, has improved its liquidity position, with a more comfortable maturity profile and Croatian kuna (HRK) 682 million (\$102 million) of committed long-term bank lines available.
- We also believe that the likelihood of timely and sufficient extraordinary support from the city to ZGH, in case of financial distress, remains high.
- We are therefore raising our rating on ZGH to 'B+' from 'B'.
- The stable outlook reflects the possibility of an improvement in the stand-alone credit profile or likelihood of extraordinary support, counterbalanced by our negative outlook on Zagreb.

## Rating Action

On Aug. 28, 2015, Standard & Poor's Ratings Services raised its long-term issuer credit rating on Zagrebacki Holding d.o.o. (ZGH) to 'B+' from 'B'. The outlook is stable.

## Rationale

The rating action reflects our view that ZGH's liquidity has improved. The company has secured several long-term committed bank lines, scaled down its capital expenditures, and has made its maturity profile more comfortable by refinancing short-term debt. Therefore, we now assess ZGH's stand-alone credit profile (SACP) as 'b-', based on a weak business risk profile and a highly leveraged financial risk profile. Under our criteria for rating government-related entities (GRES), a combination of the 'b-' SACP, high likelihood of extraordinary state support, and our 'BB' rating on the city of Zagreb results in a rating of 'B+' for ZGH.

In accordance with our criteria for rating GRES, our view of the high likelihood of extraordinary government support is based on our assessment of ZGH's:

- Very important role in providing essential municipal services, such as transport, gas, and water supplies, and waste collection, as well as its role as the city's financial vehicle in the context of the strict legal limits imposed on municipal borrowing in Croatia. Also, ZGH arranges financing for the city's infrastructure projects as national legislation limits the city's own debt-raising capacity.
- Strong link with Zagreb. The city government has a strong influence on ZGH's strategy, and we do not anticipate any challenge to the city's 100% ownership in the medium term. Although the holding is currently undergoing a corporate restructuring, we believe it will retain operational control over the main companies and branches that provide municipal services. We also assume that, were

ZGH to default, it would affect the city's reputation in the market. However, the city's ability to provide timely support to the holding has weakened, as its cash position has been low to modest since 2009.

Our assessment of the business risk profile reflects ZGH's weak regulatory environment, its poor operational performance (for instance, water leakage of ZGH's water-supply subsidiary amounts to about 50% of the total water supply), low profitability, and track record of inefficient decisions and negative returns. These weaknesses are offset by ZGH's monopoly position as a provider of public services, strong ongoing support from its owner via operating and capital subsidies, guarantees on some debt (which is repaid indirectly from the city's budget), and asset transfers. Overall, transfers from the city's budget make up almost 23% of the company's revenues and about 45% when taking financing, rents, and subsidies into account. The city's government determines the makeup of ZGH's management board, most tariffs for its regulated businesses, and its investment plan.

Transfers from the city's budget continue to be an important revenue source for ZGH, despite recent reductions, as the city is faced with a more strained revenue situation itself. The city continues to be involved in finding a new management team for ZGH and supports the holding in its restructuring program. It has also helped restructure the company's past-due leasing obligations and concluded a number of new agreements to rent and acquire real estate owned by ZGH. ZGH then sold these receivables to local banks and managed to significantly reduce its overdue payables and stock of short-term debt.

Because of our view of the high likelihood of extraordinary support from Zagreb, the rating on ZGH is two notches higher than its 'b-' SACP.

We assess ZGH's financial risk profile as highly leveraged. In our base-case scenario, the debt burden will remain high over 2015-2016, with debt to EBITDA projected to average a high 5.7x-6.5x and FFO to debt staying at about 12%. We expect neither material deleveraging nor significant amounts of new debt in the next two years. We also note that more than 80% of the group's debt is euro-denominated without any hedges in place, which is why we apply a negative capital structure modifier.

Since 2008, ZGH has lacked a viable long-term financial strategy, and this weighs on the rating via the weak management and governance assessment modifier. The holding also remains subject to the city's politically motivated decisions on mandates and sources of income.

## **Liquidity**

ZGH's liquidity has improved, and we now assess it as less than adequate, under our criteria. We expect that liquidity sources available to the group will exceed its liquidity used by more than 1.2x over the 12 months from Aug. 12, 2015.

We estimate principal liquidity sources for the period as:

- Balance sheet cash of about HRK324 million.

- HRK682 million available under long-term committed bank lines.
- HRK470 million in cash flow from operations.

This compares with the following principal liquidity uses:

- Short-term maturities of about HRK500 million.
- Capital expenditures of about HRK350 million.

The company owns significant real estate assets. It initially planned to start selling these to private entities in 2008, with the proceeds going to repay debt. However, the continuous slump in the real estate market has delayed the sale of these assets by more than six years. We do not incorporate any related cash inflows into our liquidity calculations.

In 2017, however, ZGH will have to repay its outstanding bond issue. Total debt maturities for that year are HRK3 billion. ZGH is planning on using a yet-to-be-issued guarantee by the city of Zagreb for the refinancing of the bond. In addition, it is planning on repaying part of the existing Eurobond, thereby reducing the overall size of the potential bond issue.

## Outlook

The stable outlook reflects our negative outlook on Zagreb, combined with our view that we might revise upward the likelihood of extraordinary state support to ZGH to very high, and revise upward its SACP to 'b', in the next 12 months.

We might revise the SACP if the company demonstrates prudent financial management policies, consistent application of its strategic view, and successfully refinances the 2017 Eurobond maturity in the next 12 months.

We might lower the rating on ZGH if its liquidity profile weakens as a result of aggressive short-term debt accumulation or reduction of the available liquidity sources. That might include lower city subsidies (compared with our base-case expectations), weaker operating and financial performance, and/or impaired profitability due to uncontrollable cost increases. A downward revision of the likelihood of extraordinary support from the city of Zagreb might also trigger a downgrade of ZGH.

## Ratings Score Snapshot

Corporate Credit Rating	B+/Stable/--
Business Risk	Weak
Country Risk	Moderately high
Industry Risk	Low risk
Competitive Position	Intermediate risk

Financial Risk	Highly leveraged
Cash Flow/Leverage	Highly leveraged
Anchor	b
Modifiers	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Negative (no impact)
Financial policy	Neutral (no impact)
Liquidity	Less than adequate (no impact)
Management and Governance	Weak (-1 notch)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile	b-
Government rating	BB (City of Zagreb)
Likelihood of government support	High (+2 notches)

## Related Criteria And Research

### Related Criteria

- General Criteria: Rating Government-Related Entities: Methodology And Assumptions - March 25, 2015
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry - March 28, 2014
- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Methodology: Industry Risk - November 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions - November 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers - November 13, 2012
- General Criteria: Stand-Alone Credit Profiles: One Component Of A Rating - October 01, 2010
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

### Related Research

- Research Update: Croatian Capital City of Zagreb Affirmed At 'BB' On Lower Debt

Burden; Outlook Negative, Aug. 14, 2015

## Ratings List

	Ratings	
	To	From
Zagrebacki Holding d.o.o.		
Issuer credit rating		
Foreign and Local Currency	B+/Stable/--	B/Stable/--
Senior Unsecured		
Foreign Currency	B+	B

Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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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