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Research Update:

Polish City of Krakow 'A-' Rating Affirmed; Outlook Stable

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Overview

- We believe that the city of Krakow's strong budgetary performance should help stabilize its moderate debt burden over the next few years.
- At the same time, we think the city's liquidity will remain adequate, due to the use of revolving bank lines.
- We are affirming our 'A-' rating on Krakow.
- The stable outlook reflects our view that in 2015-2017 Krakow will maintain sound budgetary performance and continue relying on bank lines for refinancing purposes.

Rating Action

On Oct. 23, 2015, Standard & Poor's Ratings Services affirmed its 'A-' long-term issuer credit rating on the Polish city of Krakow. The outlook is stable.

Rationale

The rating is based on Poland's evolving but balanced institutional framework, under which Polish cities operate. The rating also benefits from Krakow's relatively wealthy economy, which we assess as average in an international context. Krakow's satisfactory financial management is, in our view, limited by quite risky liquidity management policies. The rating also takes into account the city's strong budgetary performance, which should help stabilize its moderate debt burden over the next few years, and our view of Krakow's adequate liquidity and low contingent liabilities.

The rating on Krakow is at the same level as our assessment of its stand-alone credit profile.

The institutional framework facilitates the relatively stable distribution of revenue sources and spending responsibilities among Poland's local and regional governments (LRGs), and broadly matches revenues to expenditures. Yearly debt service on municipal borrowings is strictly regulated, which we consider prudent. This encourages municipalities to improve transparency and long-term planning, contain operating spending, increase local taxes and fees, privatize assets, and rely on long-term amortizing debt.

That said, the system enables municipalities to express their opinions on an upcoming change to intergovernmental relations through various associations. They can therefore mitigate the effect of adverse changes. Nevertheless, the system is relatively new and may change again. For example, the central government could decentralize some burdensome tasks or implement changes to equalization systems in the future. The system includes a "horizontal" element intended to help

municipalities share costs. However, we believe enforcement may be a problem because some entities openly oppose contributing to the system.

Krakow, Poland's second-largest city, benefits from a wealthy economy, with GDP per capita at almost \$22,000 (2014 estimate), outperforming the national average by 53%. As a tourist center, Krakow's economy is somewhat concentrated in the services sector, but benefits from considerably lower unemployment than the national average. In 2015-2017, we expect the city's real GDP to increase by 3.3% to 3.5% annually, in line with our forecast for Poland, with a corresponding effect on revenues.

Krakow's budgetary performance was helped considerably by its decision to raise local real estate and vehicle taxes and fees, as well as public transport ticket prices, in 2013. We estimate the share of modifiable revenues at a relatively high 39% of operating revenues on average in 2013-2017. At the same time, we note that Krakow has reached the upper legal limit of some of its taxes and fees, which further constrains its revenue flexibility. Flexibility on operating spending is limited by a high share of social expenditure, which accounts for more than 50% of the city's operating spending. Moreover, we believe capital spending flexibility is weak because more than 50% of it is cofinanced with EU funds.

We anticipate that Krakow will close 2015 with roughly balanced figures after capital accounts and a stable operating surplus of 9.4% of operating revenues, about the same level achieved in 2014. In our base case for 2015 to 2017, we forecast sustainably high operating surpluses and balanced figures after capital accounts on average, broadly similar to the average performance in 2012-2014.

Moreover, we expect Krakow to stick to its tight long-term financial policy. Under Poland's current national regulation for municipal borrowings, implemented in 2014, an LRG's debt service may not exceed the three-year average operating surplus plus privatization receipts. This leaves the city with little choice but to maintain a sound operating surplus. However, Krakow has already completed the most urgent investment projects, and it has not announced new investments. We see the city's ability to maintain a stable budgetary performance and implement infrastructure development projects, in line with its long-term financial plan, as positive for the ratings. However, the city's policy of keeping low cash reserves poses high risk, in our view, and we regard it as a weakness.

Because of the tighter municipal borrowing restrictions, Krakow has increased debt via municipal companies, notably Krakowski Holding Komunalny S.A. (KHK; a holding company) and Miejskie Przedsiębiorstwo Wodociągów i Kanalizacji S.A. (MPWIK; a water and sewage company). KHK is constructing a thermal waste-treatment plant with subsidies from the EU, and MPWIK is developing a water and sewage network. To support the construction of the waste-treatment plant, the city has issued guarantees of Polish zloty (PLN) 390 million (about €92 million). Consequently, Krakow's tax-supported debt will likely increase to 64% of consolidated operating revenues by year-end 2017, compared with 55% in 2014. Nonetheless, we consider this amount of debt moderate in an international comparison. Foreign exchange rate risks are low because only about 6% of the city's debt is denominated in euros, and all new borrowings will be denominated in local currency.

Since we include the municipal companies' debt in the city's tax-supported debt, we view the city's contingent liabilities as low. According to the city's management, Krakow faces no other contingency risks.

Liquidity

We view Krakow's liquidity as adequate, as our criteria define this term. Net free cash, liquid assets, and available committed bank lines account for 119% of debt service falling due over the next 12 months. We anticipate that the city's access to external liquidity will remain satisfactory during this period. Debt service is relatively high at between 5% and 7% of operating revenues, but significantly lower than in past years, following the decision to replace short-term debt with long-term borrowings.

For refinancing purposes, Krakow relies on its revolving PLN200 million liquidity line, which will be renewed before the end of next year.

Krakow is also exposed to market interest rates and foreign exchange risks because most of its borrowings are at variable interest rates. That said, we consider this risk to be moderate in the short term.

Our Banking Industry Country Risk Assessment places Poland's banking sector in group '5' on a scale of '1' to '10', with group '1' denoting the lowest-risk banking industries. Under our criteria for rating LRGs, this would, in principle, lead us to expect Krakow to have limited access to external liquidity. However, our criteria interpretation takes into account Krakow's proven track record of market-based funding, even during periods of market turbulence. We therefore assess the city's access to external liquidity as satisfactory.

Outlook

The stable outlook reflects our view that in 2015-2017 Krakow will maintain sound budgetary performance and continue relying on bank lines for refinancing purposes.

We could lower the rating if the city's management decreased the size of the revolving bank line, which might result in less than adequate debt-service coverage over the next 12-24 months.

Any upside rating potential over the next 12-24 months is contingent on the raising of our long-term foreign currency rating on Poland. In addition, we believe that more predictable political policies and less risky liquidity management could be positive for the rating.

Key Statistics

Table 1

City of Krakow Financial Statistics

(Mil. PLN)	--Fiscal year end Dec. 31--					
	2012	2013	2014	2015bc	2016bc	2017bc
Operating revenues	3,267	3,478	3,743	3,856	3,929	4,034
Operating expenditures	3,032	3,175	3,334	3,492	3,588	3,683
Operating balance	235	303	409	364	341	351
Operating balance (% of operating revenues)	7.2	8.7	10.9	9.4	8.7	8.7
Capital revenues	178	257	304	352	250	250
Capital expenditures	456	465	741	750	650	600
Balance after capital accounts	(43)	95	(28)	(35)	(59)	1
Balance after capital accounts (% of total revenues)	(1.2)	2.5	(0.7)	(0.8)	(1.4)	0.0
Debt repaid	435	337	236	187	196	183
Balance after debt repayment and onlending	(477)	(243)	(264)	(222)	(255)	(182)
Balance after debt repayment and onlending (% of total revenues)	(13.9)	(6.5)	(6.5)	(5.3)	(6.1)	(4.2)
Gross borrowings	420	304	241	230	260	180
Balance after borrowings	(57)	61	(23)	8	5	(2)
Operating revenue growth (%)	3.6	6.4	7.6	3.0	1.9	2.7
Operating expenditure growth (%)	7.5	4.7	5.0	4.8	2.7	2.7
Modifiable revenues (% of operating revenues)	36.1	37.6	39.0	38.9	39.2	39.4
Capital expenditures (% of total expenditures)	13.1	12.8	18.2	17.7	15.3	14.0
Direct debt (outstanding at year-end)	2,004	1,977	1,982	2,025	2,089	2,086
Direct debt (% of operating revenues)	61.3	56.8	53.0	52.5	53.2	51.7
Tax-supported debt (% of consolidated operating revenues)	61.5	57.0	54.9	64.3	65.4	63.9
Interest (% of operating revenues)	3.3	2.6	2.0	1.7	2.0	2.0
Debt service (% of operating revenues)	16.6	12.2	8.3	6.6	7.0	6.5

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects Standard & Poor's expectations of the most likely scenario. PLN--Polish zloty.

Table 2

City of Krakow Economic Statistics

	--Fiscal year end Dec. 31--					
	2012	2013	2014	2015bc	2016bc	2017bc
Population	758,334	758,992	761,873	762,635	763,398	764,161
GDP per capita (PLN)	64,808	66,684	69,331	72,475	76,363	80,856
Real GDP growth (%)	1.9	1.5	3.5	3.5	3.4	3.3
Unemployment rate (%)	5.8	5.8	5.2	5.0	4.8	4.5

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, Eurostat, and Experian Limited. bc--Base case, reflects Standard & Poor's expectations of the most likely scenario. PLN--Polish zloty.

Ratings Score Snapshot

Table 3

City of Krakow Ratings Score Snapshot

Key rating factors

Institutional framework	Evolving but balanced
Economy	Average
Financial management	Satisfactory
Budgetary flexibility	Weak
Budgetary performance	Strong
Liquidity	Adequate
Debt burden	Moderate
Contingent liabilities	Low

*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the rating.

Key Sovereign Statistics

- Sovereign Risk Indicators, Oct. 12, 2015. An interactive version is available at www.spratings.com/sri.

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign - December 15, 2014
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013

- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs - October 15, 2009

Related Research

- Banking Industry Country Risk Assessment: Poland - June 30, 2015
- Default, Transition, and Recovery: 2014 Annual International Public Finance Default Study And Rating Transitions - June 8, 2015
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions - May 18, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

Rating		
	To	From
Krakow (City of)		
Issuer credit rating		
Foreign and Local Currency	A-/Stable/--	A-/Stable/--

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at

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