MOODY'S
INVESTORS SERVICE

Credit Opinion: Ekurhuleni, Metropolitan Municipality of

Global Credit Research - 25 Jul 2014

South Africa

Ratings

Category	Moody's Rating
Outlook	Negative
NSR Issuer Rating -Dom Curr	Aa3.za
NSR ST Issuer Rating -Dom Curr	P-1.za
NSR Senior Unsecured -Dom Curr	Aa3.za

Contacts

Analyst	Phone
Daniel Mazibuko/Johannesburg	27.11.217.5470
Francesco Soldi/Milan	39.02.9148.1100
David Rubinoff/London	44.20.7772.5454

Key Indicators

Ekurhuleni, Metropolitan Municipality of

	2009	2010	2011	2012	2013
Net direct and indirect debt/Operating revenue (%)	15.9	19.2	22.6	20.8	20.6
Interest Payments/Operating Revenue (%)	1.8	2.4	2.4	2.3	2.5
Gross Operating Balance/Operating Revenue (%)	-6.6	0.2	2.5	6.6	8.5
Cash Financing Surplus (Requirement)/Total Revenue (%)	-22.5	-8.4	-4.8	5.2	5.2
Intergovernmental Transfer/Operating Revenue (%)	18.0	17.4	17.2	16.6	16.5
Real GDP (% change) [1]	-1.7	3.2	4.0	2.9	-
GDP per capita as % of National Average	158.7	150.6	145.4	146.4	-

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

The Aa3.za/P-1.za national scale issuer and debt ratings of Ekurhuleni Metropolitan Municipality reflect its relatively large economic base, its strong liquidity, and its traditionally conservative approach to financial management. However, the ratings also reflect the challenges associated with growing, albeit moderate, debt levels (including exposure to municipally owned entities' anticipated increasing debt) and the city's high expenditure requirements over the medium term.

National Peer Comparison

The City of Ekurhuleni is rated at the high end of the range of South African municipalities, whose ratings span from Aa3.za to Baa2.za. Ekurhuleni's relative position reflects debt and debt service levels that are lower than the median of the rated metropolitan municipalities, its strong liquidity position and its conservative financial management.

Credit Strengths

- good financial performance, which reflects strong revenue growth

- historically strong liquidity position

- conservative financial management

- a relatively large economy, with a strong industrial base

Credit Challenges

- high capital expenditure pressure for service delivery

- gradually increasing debt levels, but yet moderate

Rating Outlook

The negative outlook on Ekurhuleni's rating mirrors the negative outlook on South Africa's sovereign rating and reflects systemic pressure.

What Could Change the Rating - Up

A stabilisation of the outlook or an upgrade of Ekurhuleni's rating could result from a stabilisation or upgrade of the sovereign rating.

What Could Change the Rating - Down

Ekurhuleni's rating is likely to follow the trajectory of South Africa's government rating. A downgrade of the sovereign rating would likely lead to downward adjustments of Ekurhuleni's rating. The city's rating would also come under pressure in the event of fiscal slippage, a weakening of its financial position and/or a higher-than-anticipated increase in financial leverage.

DETAILED RATING CONSIDERATIONS

Ekurhuleni's Aa3.za rating combines (1) the entity's baseline credit assessment (BCA) of baa1, and (2) a moderate likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

GOOD FINANCIAL PERFOMANCE, WHICH REFLECTS STRONG REVENUE GROWTH

Based on a total revenue of ZAR22.2 billion ($2.1 billion) for the fiscal year ending (FYE) June 2013, Ekurhuleni ranks third among the five metropolitan municipalities rated by us in South Africa, after Cape Town (Aa3.za negative) and Johannesburg (A1.za negative). The city recorded a robust revenue growth of 16% on average during 2011-13. The strong budgetary performance was underpinned by growing revenue base, which is largely driven by service charges, property rates charges as well as consistent growth in fiscal transfers from national government. Combined with continued fiscal discipline, these key revenue drivers contributed to an improvement in gross operating margins to 8.5% in FYE 2013 from 6.6% in FYE 2012.

Discretionary own-source revenues constitute 83%, indicating the city's relatively high revenue autonomy. On the expenditure side of operations, non-discretionary items, such as employee costs for its approximately 15,000 staff members and bulk purchases, represent a large and growing proportion (62%) of total expenditure. Ekurhuleni's spending on repairs and maintenance constitutes 9% of total expenditures, higher than that of its rated peers.

HISTORICALLY STRONG LIQUIDITY POSITION

Continued focus on revenue collections and tight control over expenditure dynamics have allowed Ekurhuleni to consolidate its strong liquidity position. The city's liquidity ratio (Current Assets/Current Liabilities - Net off 50% of Balance sheet Debtors) improved to 1.2x in FY 2013, up from a four-year low of 0.6x in FYE 2010.

Accompanied by the city's historical policy strategy to keep expenditure within revenue-generating capacity levels, increased revenue collection (92%) has helped the city to record robust cash reserves of ZAR4.3 billion in FY

2013, equivalent to 21% of total expenditure. Going forward, the city projects cash and cash equivalents to increase moderately notwithstanding the expected increase in cash contributions from its own sources in funding capital investments.

CONSERVATIVE FINANCIAL MANAGEMENT

Ekurhuleni has traditionally displayed conservative financial management and good budgetary planning. Whilst the municipal administration was able to focus on strengthening revenue collection and prudently continued to manage its spending dynamics, the city's intention to reduce infrastructure backlogs via annual capex increases in the medium term will likely suppress financial performance and exert modest pressure on financial leverage.

HIGH CAPITAL EXPENDITURE PRESSURE FOR SERVICE DELIVERY

On the capital side of the budget, the city increased spending on infrastructure projects to ZAR2.3 billion in 2013 from ZAR2.0 billion in 2012. Nonetheless, going forward, the city plans to substantially increase annual capital expenditure to an average of ZAR3.7 billion per annum in the medium term. It will fund this capital expenditure largely through capital grants from the national government (55%), new borrowings (32%) and from own funds (13%).

GRADUALLY INCREASING DEBT LEVELS, BUT YET MODERATE

Ekurhuleni's net direct debt amounted to ZAR4.4 billion as of 30 June 2013, which is equivalent to a moderate 21% of operating revenue and a slight decrease from 23% in FY 2011. The new bond issuance of ZAR785 million in April 2014 increased total debt stock of ZAR5.2 billion at FYE 2014. Although Ekurhuleni's debt stock is moderately increasing year on year, its debt ratio remains flat, thanks to constant revenue growth.

Ekurhuleni's debt stock is 53% bonds and 47% amortising bank loans, with an average debt maturity of six years. We expect that Ekurhuleni's debt burden will remain moderate in the medium term, despite the acceleration in capital expenditure and the consequent increase in borrowing requirements. Interest expenses will amount to approximately ZAR620 million, or 2.5% of operating revenue, for FYE 2014. They will likely remain moderate and grow in line with financial leverage in the medium term.

The city's commitment to focusing on infrastructure investments will continue to require debt financing. The city's debt levels will increase moderately in the medium term as a result of (1) ongoing bond issuances under the domestic medium-term note programme for financing capital expenditure and (2) its exposure to the ZAR550 million debt guarantee available for drawdown by East Rand Water Care Company. Nonetheless, growing revenue will mitigate the fiscal pressure stemming from rising debt levels.

A RELATIVELY LARGE ECONOMY, WITH A STRONG INDUSTRIAL BASE

Ekurhuleni displays a large and relatively dynamic economic base. The local economy is driven by manufacturing; however, contribution by wholesale and retail trade as well as finance and business services to the local economy is significant and provides some diversification.

The municipality has a population of about 3.2 million, accounting for 26% of Gauteng Province's and 6.2% of South Africa's total population and it contributes around 7% to national economic output. Transport networks are well developed and have contributed to notable industrial growth in the area over the years. The metropolitan municipality is home to the Oliver Tambo International Airport, the busiest airport in Africa. The Local Economic Development plan of the city identified a number of economic development projects, which will largely take place around the airport precinct.

Typical of large municipalities in South Africa, migration into the area is an inherent challenge, with growing informal settlements in the area putting significant expenditure pressure on provision services, including housing.

Extraordinary Support Considerations

The moderate likelihood of extraordinary support from the national government reflects our assessment of the national government's policy stance, at the jurisdictional level, on promoting greater accountability and financial sustainability for South African municipalities. The reputation risk for the central government is modest given the large predominance of bank loans instead of bonds. Although the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bail-out actions to avoid defaults on debt obligations. However, the government has some interest in addressing major financial problems that could be experienced by the metropolitan municipalities given their relative importance countrywide.

Output of the Baseline Credit Assessment Scorecard

In the case of Ekurhuleni, the BCA matrix generates an estimated BCA of baa2, close to the BCA of baa1 assigned by the rating committee.

The matrix-generated BCA of baa2 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Baa1, as reflected in the sovereign bond rating (Baa1 negative).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated BCAs from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of standalone credit strength, and higher ratings are generally likely among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual BCAs, and the scorecard is not a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Ekurhuleni, Metropolitan Municipality of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Regional GDP per capita/national GDP per capita (%)	1	146.14	70%	1	20%	0.2

Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	5	20%	1
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance/operating revenues (%)	5	4.46	12.5%	1.75	30%	0.53
Interest payments/operating revenues (%)	3	2.34	12.5%			
Liquidity	1		25%			
Net direct and indirect debt/operating revenues (%)	1	20.80	25%			
Short-term direct debt / total direct debt (%)	1	4.00	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.03(2)
Systemic Risk Assessment						Baa1
Suggested BCA						baa2

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

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