



RATING ACTION COMMENTARY

Fitch Affirms Polish City of Olsztyn at 'BBB'; Outlook Stable

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Fitch Ratings - Warsaw - 15 May 2020: Fitch Ratings has affirmed the Polish City of Olsztyn's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDR) at 'BBB'. The Outlooks are Stable.

The affirmation reflects Fitch's view that Olsztyn's operating performance and debt ratios will remain in line with 'BBB' rated peers' over the medium term, despite an expected economic downturn triggered by the coronavirus pandemic, and the central government's recent decisions to cut personal income tax (PIT) and increase teachers' salaries. Fitch assesses Olsztyn's Standalone Credit Profile (SCP) at 'bbb'.

While Polish local and regional governments' (LRG) most recently available data may not have indicated performance impairment, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and some form of government restrictions are maintained or broadened due to the coronavirus pandemic. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Fitch assesses Olsztyn's risk profile as 'Midrange', in line with other Fitch-rated Polish cities'. The risk profile (or debt tolerance) reflects a moderate risk of the city's operating balance shrinking over the medium-term to levels that are insufficient to cover debt service or of annual debt service rising above our expectation. The risk profile combines one 'Weaker' key factor (revenue adjustability) - with 'Midrange' assessment of the remaining five factors (revenue robustness, expenditure framework and liabilities and liquidity framework).

Revenue (Robustness) Assessed as 'Midrange'

We assess Olsztyn's revenue robustness as 'Midrange' in view of the city's stable revenue with revenue growth prospects being in line with national GDP growth. Tax revenue accounted for almost 38% of Olsztyn's operating revenue in 2019, driven by moderately cyclical economic activities. PIT accounted for 25% of operating revenue; local taxes for 11%; and corporate income tax (CIT), a more volatile revenue item, for less than 2%. Current transfers accounted for more than 46% of operating revenue in 2019, the majority of which were transfers from the Polish State budget (A-/Stable). These transfers are not subject to discretionary changes as the majority of them are defined by law. Olsztyn's tax base is diversified with no concentration risks.

Revenue (Adjustability) Assessed as 'Weaker'

We assess Olsztyn's ability to generate additional revenue in response to possible economic downturns as 'Weaker', in line with the majority of Polish cities', but this is mitigated by a record of revenue growth, even in times of lower GDP growth.

Income tax rates are set by the central government, as are the majority of current transfers. Olsztyn has little flexibility on local taxes (11% of operating revenue) as the city's ability to determine rates on local taxes is constrained by tax ceilings set in national tax regulations. The city can potentially increase its revenue with active asset sales (on average PLN35 million of proceeds in 2014-2019, ie. about 4% of current revenue), but this source of revenue may prove unsustainable in an economic downturn.

Expenditure (Sustainability) Assessed as 'Midrange'

Fitch assesses the city's expenditure sustainability as 'Midrange', in line with the majority of Polish cities'. The city's main responsibilities are non-cyclical, including education, public transport, municipal services, administration, housing, culture, sport, as well as public safety and family benefits that are mandated and financed from the central budget.

Operating spending has generally grown in line with that of operating revenue, yielding an average operating margin of 5% in 2014-2019 (excluding one-off revenues, such as VAT refunds). Capex is linked to availability of non-returnable EU grants and is expected by Fitch to remain high in 2020-2024, leading to a budget deficit on average of 3% of total revenue.

Expenditure (Adjustability) Assessed as 'Midrange'

Fitch assesses the city's ability to reduce spending in response to shrinking revenue as 'Midrange'. The city can reduce at least 10% of its operating expenditure. Capex is, to some extent, flexible as investments tend to be implemented in phases, and can be reduced or postponed in case of need. The city has scope to scale back capex, which represents a high share of total spending. In 2019 the city's capex amounted to PLN173 million or 13% of total expenditure, below the average of 19% of rated cities in Poland.

Mandatory responsibilities account for 70% of operating expenditure, including education, social care, administration, public safety and family benefits. The city has higher spending flexibility on other sectors, including public transport, culture, sport, healthcare, and housing.

Liabilities and Liquidity (Robustness) Assessed as 'Midrange'

Fitch assesses the national framework regulations for Polish LRGs' liabilities and liquidity as 'Midrange'.

At end-1Q20 the city's loan portfolio was dominated by bonds at 89% (with final maturity up to 2035) and the remainder being loans from local banks. However, the maturity profile is smooth with average principal repayments not exceeding 11% of outstanding debt. The city's debt is in Polish zloty, however, more than 90% of it has floating interest rates, which exposes the city to interest-rate risk. This is

partially mitigated by prudent debt management by setting aside more liquidity than is necessary for debt service.

Liabilities and Liquidity Framework (Flexibility) Assessed as 'Midrange'

Fitch assesses the city's liquidity framework as 'Midrange' given the lack of emergency liquidity support from upper tiers of government, but Olsztyn has liquidity available under its committed liquidity line (with a limit of PLN50 million).

The city has a history of good liquidity, with a liquidity coverage ratio averaging 2.1x in 2010-2019. Cash in the city's accounts during 1Q20 was on average above PLN78 million, exceeding scheduled debt servicing in 2020 by almost 2x.

Debt Sustainability Assessment: 'a'

Under our Rating Criteria for LRGs Fitch classifies Olsztyn - as with all other Polish LRGs - as type B as it covers debt service from its cash flow on an annual basis.

Fitch has revised its rating-case assumptions to factor in the expected economic downturn triggered by the coronavirus pandemic. Our revised rating case projects a weaker operating balance leading to deterioration of the debt payback ratio (primary metric of debt sustainability for Type B LRGs; net adjusted debt-to-operating balance) in 2020-2024 to around 11x (2019: 5.5x).

For the secondary metrics, Fitch's rating case projects that the fiscal debt burden will continue to increase following investments, but still remain strong at around 31% in 2024.

The strong fiscal debt burden counterbalances the city's weak synthetic debt service coverage ratio (SDSCR) of around 1.0x in 2024. However, Olsztyn's debt sustainability metrics remain in line with the current SCP.

Olsztyn is a medium-sized city with over 172,000 inhabitants and is the capital of Warminsko-Mazurskie Region in northeast Poland. The region is among the bottom-five Polish regions by wealth indicators, and is eligible for additional EU grants for regional development (Operational Programme Eastern Poland 2014-2020). However, Olsztyn is a major administrative, business, cultural and educational centre in the region. In Fitch's opinion the city's wealth indicators are likely to be above or at least at the national average. The city's economy is

diversified, with services playing an important role. This sector contributed about 63.3% of the sub-region's gross valued added in 2017, above the regional average. The unemployment rate in the city (2019: 2.7%) is lower than the national average (5.2%), and much lower than the regional average (9%).

DERIVATION SUMMARY

Olsztyn's 'bbb' SCP reflects a 'Midrange' risk profile and an 'a' debt sustainability. Olsztyn's SCP assessment also factors in peer comparison. The city's IDRs are not affected by other rating factors.

KEY ASSUMPTIONS

Qualitative assumptions and assessments:

Risk Profile: Midrange

Revenue Robustness: Midrange

Revenue Adjustability: Weaker

Expenditure Sustainability: Midrange

Expenditure Adjustability: Midrange

Liabilities and Liquidity Robustness: Midrange

Liabilities and Liquidity Flexibility: Midrange

Debt sustainability: 'a' category

Support: N/A

Asymmetric Risk: N/A

Sovereign Cap: no

Quantitative assumptions - issuer-specific

Fitch's rating case is a 'through-the-cycle' scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2015-2019 figures and 2020-2024 projected ratios.

The key assumptions for the rating case include:

- Operating revenue CAGR of 3.9% in 2020-2024
- Operating expenditure CAGR of 4.1% in 2020-2024
- Capital revenue averaging 5% of total revenue and capex averaging 9% of total expenditure up to 2024
- Average debt cost rising to 3.6% in 2024 from 2.3% in 2019

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Debt payback ratio not exceeding 10x on a sustained basis under Fitch's rating case.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Debt payback ratio rising above 12x on a sustained basis under Fitch's rating case.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete

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REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

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The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Olsztyn, City of	LT IDR	BBB	Affirmed
●	LC LT IDR	BBB	Affirmed

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Additional information is available on www.fitchratings.com**APPLICABLE CRITERIA**[Rating Criteria for International Local and Regional Governments \(pub. 13 Sep 2019\) \(including rating assumption sensitivity\)](#)**ADDITIONAL DISCLOSURES**[Dodd-Frank Rating Information Disclosure Form](#)[Solicitation Status](#)[Endorsement Policy](#)**ENDORSEMENT STATUS**

Olsztyn, City of

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