Moody's Investors Service

Global Credit Research
Credit Opinion
13 JUL 2009

Credit Opinion: Poprad, City of

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Slovak Republic

Ratings

Category	**Moody's Rating**
Outlook	Stable
NSR Issuer Rating -Dom Curr	Aa1.sk

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Key Indicators

Poprad, City of

	2004	**2005**	**2006**	**2007**	**2008**
Net Direct and Indirect Debt/Operating Revenue (%)	**15.9**	**14.8**	**11.3**	**8.5**	**9.4**
Interest Payments/Operating Revenue (%)	**1.0**	**0.6**	**0.6**	**0.5**	**0.5**
Gross Operating Balance/Operating Revenue (%)	**6.3**	**14.4**	**15.6**	**14.9**	**16.5**
Cash Financing Surplus (Requirement)/Total Revenue (%)	**8.8**	**8.5**	**-2.6**	**9.7**	**8.9**
Discretionary Own Source Revenue/Operating revenue (%) [1]	**33.0**	**28.7**	**28.3**	**27.1**	**28.8**
Self-financing ratio	**1.0**	**1.0**	**0.9**	**1.0**	**1.0**
Capital spending/Total expenditure (%)	**22.8**	**26.7**	**38.0**	**16.2**	**28.3**

[1] Own taxes + non-tax revenue

Opinion

SUMMARY RATING RATIONALE

The City of Poprad's national scale issuer rating of Aa1.sk reflects a number of factors, including the solid track record of prudent fiscal policy applied by the city's administration as envisaged in solid overall budgetary performance. The rating also takes into account the city's low debt burden and robust cash reserves and factors in some uncertainty related to the scale of its budgetary response to a potentially deeper-than-expected recession.

The City of Poprad is rated as one of the top Slovak municipalities, whose ratings span from Aa1.sk to Aa3.sk. The city's position relative to national peers reflects very low debt and debt service levels, below the median of Aa.sk-rated municipalities in Slovakia, as well as gross operating balances and a liquidity profile that are stronger than the median of Aa.sk-rated Slovak municipalities.

Credit Strengths

Credit strengths for the City of Poprad include:

Prudent fiscal and debt management policies

Consistent operating surpluses and solid financing results over time

Low debt burden

Very good liquidity

Credit Challenges

Credit challenges for the City of Poprad include:

Deeper-than-expected recession and its impact on operating performance

Limited revenue flexibility and rigid expenditure structure typical for all Slovak municipalities

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

An upward trend in the rating is unlikely in the medium term.

What Could Change the Rating - Down

A reversal of the city's existing prudent fiscal and debt management policies, combined with a significant increase in the stock of debt, could exert downward pressure on the rating.

DETAILED RATING CONSIDERATIONS

The rating assigned to the City of Poprad reflects the application of Moody's Joint-Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the Baseline Credit Assessment (BCA) for the city and then considers the likelihood of support coming from the national government to avoid an imminent default by the city, should this extreme event ever occur.

Baseline Credit Assessment

The City of Poprad's BCA of 7 (on a scale of 1-21, where 1 represents the lowest credit risk) reflects the following factors:

Financial Position and Performance - Poprad's gross operating balance (GOB) was in the narrow range of 14-16% of operating revenues over the past four years, confirming the remarkable stability of its operating performance. Like most Slovak municipalities, Poprad's operating results have benefited from financial reform since 2005. The reform enabled municipalities to gain more from the fast-growing national economy through the new distribution mechanism of the key tax (personal income tax, PIT). However, we believe that it is mainly the city's focused fiscal planning and traditionally effective cost controls that make it the best-performing municipality in our Slovak-rated universe. For instance, the city reported the lowest personnel cost dynamics in 2005-08 (CAGR +5.5%) of all its Slovak peers, with a share of operating expenditure dropping to 19% in 2008, from 21% in 2005.

Thanks to prudently managed budgets over the past few years, the city is well prepared for the current period of economic downturn, which is expected to weigh on key tax revenues in 2009-10. The latest forecast from the Ministry of Finance suggests a decline of around 5% in municipal tax revenues compared with 2008. The city is expected to revise its budget during Q3 2009, but it has already tightened its cost controls and identified around 5% of operating expenditure to be cut. These measures might not be enough to preserve GOB at the 2005-08 level; therefore, a modest decline to the low double-digit range is expected in 2009-10. We believe that the risk arising from a prolonged recession in the national economy, which could possibly add pressure to the city's operating margins, is somewhat mitigated by the administration's proven ability to adapt its budgetary policy to the changing environment.

Management's typically cautious capital investment (capex) implementation strategy has been firm over the past few years. The solid operating performances along with the strong inflow of capital revenues has enabled Poprad to proceed with some high-volume investments without incurring any substantial increase in debt over the past five years. Moreover, the solid pre-funding surpluses the city has posted over most of this period have enabled Poprad to accumulate solid cash reserves (54% of the city's operating revenue in 2008) that will boost its capital spending in 2009-10.

Although Poprad's sizeable capex programme implies some flexibility, management has clearly articulated that it will not be the subject of any significant cost-cutting measures. The ongoing major projects concerning social housing, roads, sewage and social infrastructure will bring the city's capex above 25% of total revenue in 2009-10 - a substantial increase from 16% in 2007. As a consequence of the upsurge in capex and weak revenue prospects, the city is expected to post a sizeable double-digit pre-funding deficit in 2009 and likely also in 2010, which will be covered by the robust cash reserves and potentially a new loan. We consider these deficits to be planned and properly managed, and therefore are unlikely to result in unsustainable development in the city's overall budget performance.

Debt Profile - Poprad's positive overall budget performance has enabled it to keep its debt burden on a declining trend over most of the past five years. The city's net direct and indirect debt-to-operating revenue ratio was 9.4% at the end of 2008, up from 8.5% the previous year and still well below the average of its Slovak peers (27%).The city has tapped into a central government soft loan (30-year maturity, low fixed interest rate) for social housing in 2008-09 that is expected to increase the city's debt burden to 13% of operating revenue at the end of 2009. Going forward, the city will consider an option to tap new debt to finish a major infrastructure upgrade if the revenue prospect remains weak in 2010. Nevertheless, we do not expect any substantial deterioration in credit metrics over the medium term, given the low debt and strong operating performance.

Poprad does not have any indirect debt exposure and its direct debt consists of local currency-denominated, long-term amortising loans with fixed and floating interest rates. The loan portfolio's weighted average maturity was a favourable 18.3 years at the end of 2008, given the dominance of central government long-term loans. The expected rise in the city's debt burden in 2009 will have no impact on its debt servicing needs, which will decline to 2% of operating revenue in 2009. Given the city's solid operating performance and its prospects, Moody's assumes that no major concerns should arise to service its existing debt.

Poprad also enjoys an excellent liquidity position. The solid financing surplus the city posted in recent years has helped the city to build up substantial cash reserves. At the end of 2008, the balances on the city's bank accounts and off-budget funds reached a remarkable 54% (up from 40% in 2007) of its operating expenses for the year, or more than 5x the outstanding debt. The city will tap its robust cash reserves to fund its extensive capex programme in 2009-10. Hence, liquidity should shrink to a still solid 20-25% in the coming years.

Governance and Management Factors - Governance and management practices are reliable and predictable. It is very unlikely that the prudent fiscal approach applied by the city over the past six years will significantly ease in the medium term. Management's ability to keep a strong grip on its operating expenditures has been reflected in sound operating margins. In addition, the city has applied a conservative investment strategy over the past few years, as seen in its healthy pre-funding surpluses. Given management's long track record, it should be capable of navigating the city through the current economic turmoil relatively smoothly.

Economic Fundamentals - The City of Poprad, with roughly 55,000 inhabitants, is located in the Region of Presov, in eastern Slovakia. Its demographic profile is characterised by long-term negative migration flows that are only partially offset by positive natural flows. Like other Slovak cities, Poprad's population is ageing. The share of Poprad's residents over the age of 65 is in line with the national average, but is expected to rise steadily. This increase will exert pressures on social services, which are a municipal responsibility in Slovakia.

The Presov Region's economy has grown rapidly, along with the national economy, over the past few years. However, the region remains Slovakia's poorest according to GDP measures (on a GDP per capita basis, the region reaches around 61% of the national average). The local economy is service-based, but has a solid industrial base. Key industrial sectors are home appliances, heavy machinery, plastic components, food processing and chemicals. Along with public services and retail, tourism is also very important to the local economy, as the city is a gateway to Slovakia's top destination - the High Tatras mountain range. The city's sound economy is mirrored in the moderately high unemployment rate, at 10.2% in May 2009, compared to 11.4% at the national level. However, it remains the lowest in the Presov region (regional average: 16.9%). In addition, the local wealth, measured by income per capita is substantially higher than the regional average. Taking into account the city's sound economic fundamentals, we assume that local GDP is significantly higher than the regional average.

The recession has already weighed on the local economy (weakening labour market). However, it is expected that the very good level of diversification will preserve the local economy from a sizeable downturn. Moody's notes that the city is exposed to revenue derived from the local economy mainly through local taxes (14% of operating revenue). Since the tax base is fairly immune to the economic downturn, the main risk arises from rising payment delinquencies. Among local taxes, only the real estate tax (8.5% of operating revenue) is particularly vulnerable. Thus, Moody's considers the associated risk as manageable.

Operating Environment - The operating environment for Slovak RLGs reflects that of OECD emerging market economies, with relatively high GDP per capita within the emerging market universe, modest GDP volatility and a relatively high ranking on the World Bank's Government Effectiveness Index. The combination of these characteristics suggests a low level of systemic risk, as reflected in the A1 rating assigned to the debt issued by Slovakia.

Institutional Framework - The framework for Slovak municipalities, which underwent major changes in 2002-04, is now relatively stable and predictable. Following a number of institutional and financial changes in recent years, the funding of municipal responsibilities and their budget structures has been gradually stabilising and is unlikely to be substantially changed in the medium term. The legal provision requiring the central government to negotiate with municipal representatives before major changes to the institutional framework can be implemented is recognised as an additional element of stability by Moody's.

The ongoing global economic downturn represents the biggest fiscal challenge for the Slovak municipal sector by far. The sharply decelerating national economy has already been weighing on municipal budgets through lower-than-expected revenue growth. In addition, the municipal representatives agreed to take part in the government's anti-cyclical measures. According to the memorandum signed with the government: (i) the PIT deduction will be increased, with negative consequences for municipal key revenue; (ii) the legal provision requiring municipal operating budgets to be balanced or in surplus will be abandoned; and (iii) the government will abandon any transfer of under-financed new responsibilities to municipalities and postpone the application of some legislation prompting higher municipal spending. Moody's understands the exceptionality of these measures and welcomes the fact that their validity is restricted to 2009-10 only. The municipalities are expected to live with lower PIT revenue in 2009-10. The central government's commitment to easing the negative impact on municipalities is rather vague; thus, even partial compensation for all entities seems very unlikely. We, therefore, assume a strong budgetary response will be needed to re-balance municipal budgets. Moody's recognises the risk arising from easing fiscal discipline/rules as more serious in the long term. We believe that even a temporary abandoning of the "golden rule" of balanced operating budgets might dent municipal sector stability and credibility.

The past few years have been demanding for Slovak municipalities. From 2009, they have instituted programme budgeting and adopted the euro. Moreover, the Slovak public sector has switched to accrual accounting under International Financial Reporting Standards (IFRS) from 2008.

Under the current local government framework, Slovak municipalities have limited scope for control over operating revenue, which is generated by PIT - set and collected nationally - and by transfers from the state budget. As much as 72% of cities' operating revenue comes from the central government in the form of shared taxes or transfers. The remainder consists of own taxes and fees, accounting for 15% of operating revenue (9% real estate tax and 6% other local taxes and fees), and other non-tax revenue (13%), thus limiting the cities' ability to tap into wealth generated by the local economy. While municipalities enjoy broad discretion over their own taxes and fees, tax rate changes are limited by the political sensitivity of this issue. The volume of cities' capital revenue is very volatile from one year to the next; it typically stems from the sale of property and earmarked transfers.

The flexibility of municipal expenditure is not much greater. Three of the main components of current expenditure - personnel (48% of 2007 operating expenditure), transfers to companies/population (14%) and interest paid on capital (1%) - are extremely rigid and municipalities' ability to control its growth is very limited. The majority of this spending is mandated by national law, with some programmes directly funded by the central government through earmarked transfers provided to the cities. The fourth category of expenditure - energy and services (37%) - is provided mostly by commercial partners, based on long-term contracts with pricing driven by the market. The only leeway the city has is flexibility over capex. However, the volume of spending on capital items is strongly correlated with capital revenue; hence, capex is highly volatile. Although capex represented 24% of total expenditure in 2007, a substantial part of capex (35%) was funded by earmarked transfers. Consequently, the Slovak municipalities' capex flexibility is significantly lower.

Slovak municipalities' direct debt level is currently low (27% operating revenue in 2007), reflecting the sufficiency of funds to finance municipal responsibilities and the limits imposed on municipal debt and debt service (which cannot exceed 60% and 25% of operating revenue, respectively). However, municipalities' debt is expected to grow going forward, under pressure from the need to upgrade municipal infrastructures to EU standards following Slovakia's entry into the EU.

Slovak municipalities enjoy adequate liquidity. Although the most important operating revenue component (PIT) fluctuates over the year, with revenues typically highest in the first quarter/half, the municipalities do not face any liquidity problems. There is almost no fluctuation on the current expenditure side and relatively high fluctuation on the capex side. As the municipalities technically enjoy full discretion over their capex, they are able to synchronise this with their cash flows.

Extraordinary Support Considerations

Moody's assigns a low likelihood of extraordinary support from the central government, reflecting the central government's track record of allowing Slovak municipalities to default and Moody's assessment of a medium level of oversight implemented by the central government.

Moody's also assigns a very high default dependence between the city and the central government, reflecting a heavy reliance on central government resources, in the form of either shared taxes, which are determined and collected nationally and redistributed on a formula basis, or transfers.

Output of the Baseline Credit Assessment Scorecard

In the case of the City of Poprad, the BCA scorecard (presented below) generates an estimated BCA of 7, the same as that assigned by the rating committee.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength; however, the estimated BCAs generated by the scorecard do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Concomitantly, scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Moreover, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our analysis. Nevertheless, the performance statistics captured in the scorecard are important and, in general, higher ratings can be expected among issuers with the highest rankings from the scorecard.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's assigns national scale ratings in certain local capital markets in which investors have found the global rating scale provides inadequate differentiation among credits or is inconsistent with a rating scale already in common use in the country. Moody's National Scale Ratings are opinions of the relative creditworthiness of issuers and issues within a particular country. While loss expectation will be an important differentiating factor in the ultimate rating assignment, it should be noted that loss expectation associated with National Scale Ratings can be expected to be significantly higher than apparently similar rating levels on Moody's global scale. Moody's National Scale Ratings rank issuers and issues in order of relative creditworthiness: higher ratings are associated with lower expected credit loss.

National Scale Ratings can be understood as a relative ranking of creditworthiness (including relevant external support) within a particular country. National Scale Ratings are not designed to be compared among countries; rather, they address relative credit risk within a given country. Use of National Scale Ratings by investors is only appropriate within that portion of a portfolio that is exposed to a given country's local market, taking into consideration the various risks implied by that country's foreign and local currency ratings.The Moody's Global Scale rating for issuers and issues in local currency 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.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

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 either low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can materially change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence. Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Poprad, City of

Baseline Credit Assessment Scorecard - 2007	**Value**	**Score**	**Sub-Factor Weighting**	**Sub-Factor Total**	**Factor Weighting**	**Total**
Factor 1: Operating Environment						
National GDP per capita (PPP basis, $US)	18,914	9	50.0%	6.75	60.0%	4.05
National GDP Volatility (%)	3.5	3	25.0%			
National Govt Effectiveness Index (World Bank)	0.76	6	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.01	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	15	15	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	7.5	7.5	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	0.5	1	33.3%	2.33	7.5%	0.18
Cash Financing Surplus(Req)/Total Revenue (%)	6.0	3	33.3%			
Gross Operating Balance/Operating Revenue (%)	15.0	3	33.3%			
Net Working Capital/Total Expenditures						
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	9.0	1	50.0%	2.25	7.5%	0.17
Short-Term Direct Debt/Direct Debt (%)	25.3	6	25.0%			
Net Debt/Operating Revenue Trend	-20.4	1	25.0%			
Factor 5: Governance & Management						
Fiscal Management	7.5	7.5	40.0%	4.90	7.5%	0.37
Investment & Debt Management	7.5	7.5	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	1	1	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated ($US)	11,456	12	100.0%	12.00	7.5%	0.90
Estimated BCA						**7**