



Credit Opinion: Sala, City of

Sala, City of

Slovak Republic

Ratings

| | |
|-----------------------------|-----------------------|
| Category | Moody's Rating |
| Outlook | Stable |
| NSR Issuer Rating -Dom Curr | Aa3.sk |

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Key Indicators

Sala, City of

| | 2002 | 2003 | 2004 | 2005 | [1]2006 |
|--|--------|-------|-------|-------|---------|
| Net Direct and Guaranteed Debt/Operating Revenue (%) | 38.60 | 38.87 | 30.67 | 37.17 | 32.25 |
| Interest Payments/Operating Revenue (%) | 2.50 | 1.53 | 1.35 | 1.14 | 1.30 |
| Gross Operating Balance/Operating Revenue (%) | 1.07 | -9.69 | -0.65 | 2.12 | 3.13 |
| Cash Financing Surplus (Requirement)/Total Revenue (%) | -22.81 | -9.09 | -1.20 | -8.26 | -2.22 |
| Own Discretionary Revenue/Operating revenue (%) [2] | 20.21 | 13.89 | 13.60 | 12.33 | 12.69 |
| Self-financing ratio | 0.59 | 0.79 | 1.00 | 0.73 | 1.00 |
| Capital spending/Total expenditure (%) | 38.11 | 30.55 | 6.80 | 21.55 | 20.80 |

[1] Budget adjusted [2] Own Discretionary Revenue comprise municipal taxes and waste management fee

Opinion

Credit Strengths

Credit strengths for the City of Sala include:

Manageable, albeit substantial, debt burden

City's commitment to expenditure controls

Credit Challenges

Credit challenges for the City of Sala include:

Limited current revenue flexibility and rigidity on expenditure side

Weak operating margins have been insufficient to cover annual debt service

Weak cash position and liquidity arising from substantial financial deficits

Ambitious PPP project and investment requirements

Rating Rationale

The Aa3.sk national scale issuer rating with stable outlook of the City of Sala was affirmed as a result of the application of Moody's Joint Default Analysis (JDA) rating methodology for regional and local governments. In accordance with this methodology, the city's rating reflects the combination of the following inputs: a) Baseline Credit Assessment (BCA) of 10 (on a scale of 1 to 21, where 1 represents the lowest credit risk); b) the A1 local currency rating of the Government of the Slovak Republic; c) 90% default dependence (degree to which the city's and Slovak Republic's default are correlated); d) 20% likelihood that the central government would act to prevent a default by the city.

Sala's BCA of 10 reflects the following factors:

The operating environment for Slovak municipalities is typical of emerging OECD economies and is characterised by moderate GDP per capita, relatively low GDP volatility and a high ranking on the Government Effectiveness Index (provided by the World Bank). These characteristics suggest a low level of systemic risk, as reflected in the A1 rating assigned to the debt issued by the national government.

However, the BCA assessment also takes into account the current local government institutional framework, the main features of which are: moderate predictability and responsiveness; very limited revenue and spending flexibility; and substantial borrowing requirements to fund capex.

After 2002, the city was not able to fully absorb sharp increases in current expenditure arising from responsibilities transferred from central government. This led to the erosion of operating margins followed by a decline in self-financing ratio, despite a slight revival of operating performances after the financial reforms of 2005.

In addition, the financial deficits registered over the last five years have weakened the city's accounts and led to substantial short-term and long-term borrowings. Neither has Sala's liquidity been very strong. However, indebtedness has been manageable to date and the city does not plan any new loans after 2008.

The city's management has decided to outsource (transfer responsibility for) part of the supply of public services and capex to private partners for 15 years beginning in 2007, whereby it will pay monthly fees. Outsourcing to such an extent is unprecedented in this context and will take time to implement fully. In Moody's view, it could put the city's budget under extensive pressures as the contractual arrangements further limits its ability to reduce current expenditure to match revenues in the advent of an economic slowdown. Moreover, savings arising from the outsourcing are not expected until after 2008.

Default Dependence:

Default dependence of 90% reflects a heavy reliance on central government resources, either in the form of shared taxes, which are determined and collected nationally and redistributed on a per capita basis, or direct transfers from state budget.

Extraordinary Support:

The 20% likelihood of extraordinary support from the central government to prevent a default reflects the government's track record of allowing municipalities to default.

Rating Outlook

The rating outlook is stable, based on the expectation that (i) the recently established institutional framework will not significantly change in the medium term and (ii) the city will maintain its stock of debt at a manageable level.

What Could Change the Rating - Up

Significant improvement in the city's financial, especially operating, performances and liquidity combined with a conservative approach to debt and operating management

Changes to the institutional framework significantly increasing spending flexibility and revenue rising capacity

What Could Change the Rating - Down

Further strong deterioration in operating margins combined with increasing stock of debt

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