GCR RATINGS

Credit Rating Notification

GCR affirms Buffalo City Metropolitan Municipality's National Scale Issuer Ratings of A(ZA)/A1(ZA), Outlook Stable

Rating Action

Johannesburg, 13 April 2022 – GCR Ratings ("GCR") has affirmed the national scale long and short term issuer ratings assigned to Buffalo City Metropolitan Municipality at A(ZA) and A1(ZA) respectively, with a Stable Outlook.

Rated Entity	Rating class	Rating scale	Rating	Outlook / Watch
Buffalo City Metropolitan Municipality	Long Term Issuer	National	A(ZA)	Stable Outlook
	Short Term Issuer	National	A1(ZA)	

Rating Rationale

The ratings reflect GCR's expectations that Buffalo City Metropolitan Municipality's ("BCMM', "the City" or "the Metro") will maintain strong leverage headroom and a sound operating performance, although some pressures on cash flow and liquidity remain evident following the effects of the coronavirus pandemic.

Cognisance is taken of BCMM's status as a metropolitan municipality, given its role as a hub of economic activity in the region and the government support received, although its economic base is small and less diverse than some of the larger metros, restricting its operational flexibility. In terms of national GDP, BCMM contributes around 1.6%, with the Metro's longer term average growth rate (from 2009-2019) of 1.45% being slightly lower than that of the national average at 1.68%. Economically, the industrial sector is an important contributor (particularly the motor industry) to the City, with it being is well positioned in East London in terms of its logistics potential. Whilst capex has increased steadily over the review period, progress on catalytic projects has been relatively slow. BCMM is located in one of the poorest provinces in South Africa, with the Metro characterised by a high unemployment rate of 34.9% (national rate: c.34.9%), giving rise to rife poverty and inequality levels. However, access to electricity, sanitation and literacy levels in the Metro are much better than the province (and in some cases in line with the national average).

BCMM has broadly maintained a sound operating preperformance over the 5-year review period, with surpluses achieved in all years except FY20 due to pandemic related income constraints. We also note the more stringent measures taken to rein in costs (5% growth in FY21, compared to double digit escalations historically), if maintained, should lead to a stronger operating performance. The income growth trend has been fairly volatile, typically benefitting from a re-rating of tariffs or valuations in certain years rather than real growth in the tax base. Moreover, deficiencies are evidenced in the high water loss ratio above the industry mean, whilst GCR is concerned about consumers' ability to absorb rising utility costs in the weak economic environment. This as collection rates remain constrained at 67% at December 2021 vs pre-COVID levels of 86% in December 2020. The debtors' creep has seen gross debtors to total income rise to 55% in FY21 from 39% in FY17 and bad debts as a percentage of debtors climb to 20% (FY17: 13%). Thus, continued pressures on cash flows could impede capex implementation efforts and the liquidity profile if not effectively managed.

BCMM's weak historic audit outcomes remains a constraint on its credit risk profile. The Metro received another qualified audit outcome in FY21, with findings relating to the potential understatement of material irregular expenditure balances due to failure to adhere to procurement protocols.

BCMM's conservative leverage profile continues to support the ratings, with the Metro remaining in a net ungeared position in FY21. The City's commitment to accelerating revenue enhancing infrastructure investments (particularly the East London Sewer Diversion tunnel) over the next three years will require increased debt financing, given own-generation income growth pressures. Nevertheless, gearing metrics are still expected to remain comfortably below 20%, with relatively sound cash generation expected to sustain strong debt serviceability. The strong leverage assessment is somewhat counterbalanced by the funding concentration to the Development Bank of South Africa. The Metro is looking to source the additional funding required in the open market, which would be a stronger indicator of demonstrated access to capital.

The City's historically large cash balances have declined over the review period as a large portion of capex has been internally funded, together with the recent cash flow pressures as a result of weaker collection rates. As such, we note some liquidity pressures, as unrestricted days cash on hand have eased to around 50 days over the past two years from historical levels well above 100 days. Nevertheless, we do consider liquidity sources to be sufficient to mitigate against the current cash flow pressures, with GCR's liquidity coverage calculated at 1.4x over the next 12 months.

Outlook Statement

The Stable Outlook reflects our expectation that the Metro will maintain conservative debt management despite an acceleration in its capex programme. In addition, GCR expects the City to preserve adequate liquidity.

Rating Triggers

Positive rating action could follow 1) Enhanced operational performance, underpinned by growth in the income base and sustained cost rigor, supporting improved cash flows; 2) sustained strengthening in liquidity and/or 3) improvement in audit outcomes.

If the Metro's debtors' collections problems persist, leading to a weaker performance and/or decrease in cash holdings/liquidity metrics, negative rating action could be taken.

Analytical Contacts

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Related Criteria and Research

Criteria for the GCR Ratings Framework, January 2022
GCR Rating Scales Symbols and Definitions, May 2019
Criteria for Rating Local and Regional Governments, June 2019
GCR's Country Risk Scores, December 2021

Ratings History

Buffalo City Metropolitan Municipality					
Rating scale	Review	Rating class	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	BBB(ZA)	Stable Outlook	Aug 2003
Short Term Issuer		National	A3(ZA)		
Long Term Issuer	Last	National	A(ZA)	Stable Outlook	March 2021
Short Term Issuer		National	A1(ZA)		

Risk Score Summary

Rating Components & Factors	Risk scores
Operating environment	**14.00**
Country & sector risk score*	14.00
Business profile	**(2.25)**
LRG Profile	(0.50)
Operating performance	(0.75)
Management & governance	(1.00)
Financial profile	**1.50**
Leverage and capital structure	2.00
Liquidity	(0.50)
Comparative profile	**0.00**
Government support floor	0.00
Peer analysis	0.00
Total score	**13.25**

*The country risk score serves as a proxy for sector risk.

Glossary

Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	With regard to corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long Term Rating	See GCR Rating Scales, Symbols and Definitions.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Risk	The chance of future uncertainty (i.e. deviation from expected earnings or an expected outcome) that will have an impact on objectives.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.

Salient Points of Accorded Ratings

GCR affirms that a.) no part of the ratings process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit ratings have been disclosed to the rated entity. The ratings above were solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the ratings.

The rated entity participated in the rating process *via* management meetings, teleconferences and other written correspondence. Furthermore, the quality of information received was considered to be adequate, and has been independently verified where possible. The information received from the rated entity and other reliable third parties to accord the credit ratings included:

- Consolidated audited Annual Financial Statements June 2021 (Plus four years of comparative numbers);
- Auditor General report for June 2021
- Debt facility breakdown at June 2021 and Dec 2021;
- The Integrated Development Plan 2021/2022;
- Schedule A accounts.