Research Update:

Bulgarian City of Sofia Outlook Revised To Positive On Improved Growth Prospects; 'BBB' Rating Affirmed

February 16, 2024

PRIMARY CREDIT ANALYST

Erik A Karlsson
Stockholm
+46(0)84405924
erik.karlsson
@spglobal.com

SECONDARY CONTACT

Maxim Rybnikov
London
+44 7824 478 225
maxim.rybnikov
@spglobal.com

ADDITIONAL CONTACTS

Oscar Palsson
Stockholm
+46 (0)721426006
oscar.palsson
@spglobal.com

Sovereign and IPF EMEA
SOVIPF
@spglobal.com

Overview

- Bulgaria's accession to the eurozone might, in our view, accelerate economic growth in the capital city of Sofia, supporting tax-revenue growth and further diversifying its funding sources.
- Strong economic fundamentals in the capital city, alongside conservative financial planning, will underpin solid operating performance and contained deficits after capital accounts, despite sizable infrastructure investments.
- We expect near-term policy continuity following the change of government after the local election in November 2023, where the incumbent administration lost power after nearly two decades in office.
- We therefore revised the outlook on the long-term issuer credit rating on Sofia to positive from stable and affirmed the rating at 'BBB'.

Rating Action

On Feb. 16, 2024, S&P Global Ratings revised to positive from stable its outlook on the long-term issuer credit rating on the City of Sofia, Bulgaria's capital. We affirmed our 'BBB' long-term issuer credit rating on the city.

Outlook

The positive outlook reflects the increased likelihood that Sofia's economic growth may strengthen on the back of Bulgaria's accession to the eurozone.

Upside scenario

We could consider an upgrade over the next 24 months if Bulgaria's successful accession to the eurozone gives way to pronounced economic and fiscal benefits for Sofia, such as strong tax-revenue growth or access to more diversified funding. An upgrade would be contingent on a similar action on the sovereign.

Downside scenario

We could revise the outlook to stable if Bulgaria's eurozone accession bears only limited effects for Sofia. A stable outlook might also stem from weaker management practices, such as those pertaining to the city's companies, that resulted in increased risks. In addition, we would revise the outlook to stable if we took a similar action on Bulgaria.

Rationale

The positive outlook captures our view that economic growth in Sofia could improve beyond our expectation thanks to Bulgaria's entry into the eurozone, which could occur in 2025. Eurozone accession would support revenue growth and wealth levels in the city. We also think adopting the euro could broaden the city's funding sources and enhance its capital access.

We forecast Sofia will maintain relatively strong budgetary performance on the back of its strong local economy, underpinning strong tax-revenue growth. Funding for EU-supported projects will be lower than in previous years, as the program cycle comes to an end, although we forecast continued investments in local infrastructure requiring debt financing. However, we think the city will maintain a low debt burden and ample liquidity reserves, counterbalancing the limited predictability of the institutional framework under which Bulgarian local and regional governments operate.

The new administration's policy implementation may be impaired by structural challenges

We continue to view Sofia's management as relatively weak in an international context. The city operates its budget conservatively, typically resulting in solid operating performance, but there is no long-term visibility on the financial planning. Although the city has some flexibility to adjust taxes and fees, the city has been reluctant to do so in the past. The treasury policies are, in our view, unsophisticated but managed conservatively. We also consider the city's implementation of capital plans and oversight of municipal companies as generally weak.

We think the city's new administration, following the late-October 2023 elections, may shift policy, focusing on enhanced efficiency. The new mayor, Mr. Vassil Terziev, who is supported by a pro-European coalition, campaigned on improving transparency and efficiency in the municipality and its companies. This could, in our opinion, reduce the risk in some of the city's companies that have long suffered from weak finances, including the troubled district heating company Toplofikacia. That said, policy implementation may be slow due to the fragmented nature of the city council and institutional challenges in the Bulgarian LRG-sector, at least in the near term.

Sofia benefits from its favorable economic position compared with domestic peers. Bulgaria's GDP per capita remains modest in an international comparison, while Sofia's wealth levels are more than double the national average. Furthermore, Sofia's population growth and employment structure have developed more favorably than Bulgaria in general. The city is the administrative and financial headquarter of Bulgaria and has a well-diversified service-based economy that houses the local stock exchange, major banks, and a healthy service sector.

We believe that the city operates under an evolving institutional framework. The central government plays an important role in the intergovernmental system, where transfers account for the majority of the sector's revenues. These transfers, however, may be unpredictable and volatile, translating into deficient long-term planning that ultimately narrows the predictability of its financial policymaking. While central government transfers are unmodifiable, a few local taxes can be set locally at a range determined by the central government; this slightly strengthens the sector's revenue-raising capacity.

Sofia's debt burden should remain contained amid infrastructure investments likely to cause modest deficits after capital accounts

We expect Sofia's operating performance will remain solid through 2026, although somewhat weaker than in previous years. Employee-related costs, representing about 50% of the city's operating expenditure (opex), are set to increase through 2026. The city suffers from a personnel shortage, and we think wage increases will remain high to support employee retention and recruiting efforts. This, alongside greater maintenance spending than last year, prompts us to expect some pressure on operating margins. However, the city has a conservative financial planning and benefits from its strong economic position, so we assume strong revenue growth. We also expect that the compensation for state-delegated responsibilities (close to 60% of total opex) will remain sufficient over 2024-2026. We think these factors will counterbalance most of the cost pressures over the forecast period.

Sofia will post modest deficits after capital accounts in 2024-2026 on the back of investments in local infrastructure. The capital program mainly includes spending related to the extension of the metro network, as well as investments on road networks, water and sewage, and urban development. Some of these projects will be fully backed by the EU. However, we expect lower EU inflows in the coming few years since the current EU cycle is coming to an end. In addition, Sofia will undertake 109 targeted projects that are fully funded by the central government, totaling Bulgarian lev (BGN) 100 million between 2024 and 2026. Our forecasts factor in that investment plans typically carry a notable delay due to capacity constraints and bureaucracy, including appeals and litigation.

Despite relatively large capital spending, we think Sofia's debt burden in relation to revenues will remain stable through 2026. Our forecast suggests Sofia will increase its nominal tax-supported debt burden, including the outstanding debt of the transportation companies, by almost 20% through 2026, which will mainly be funded via borrowings from the European Investment Bank (EIB). However, we expect revenue growth will remain strong and balance the increasing debt. Furthermore, Sofia adheres to conservative debt management practices, with fixed-rate issuances, limiting the exposure to elevated interest rates.

We continue to regard the financially weak municipal sector as a credit weakness for Sofia. We estimate the contingent liabilities--mainly related to the utility company Toplofikacia--amount to about 50% of consolidated revenues. At the end of 2023, Toplofikacia had accumulated more than BGN1.5 billion of liabilities, mainly payables, toward central government gas distributors, which it has built up because of an unfavorable regulation for district heating providers in Bulgaria. We understand the city and the central government are discussing the situation, and we note that the central government in its 2024 budget stated it may acquire up to BGN1.6 billion of Toplofikacia's receivables from the gas suppliers.

We expect Sofia will maintain sound liquidity, underpinned by high cash reserves relative to the volume of maturing debt. Free cash reserves and liquid assets for the coming 12 months will cover about 360% of debt service. We continue to view the city's access to external liquidity as limited due to its concentrated funding sources.

Key Statistics

Table 1

City of Sofia--Selected Indicators

	--Fiscal year ends Dec. 31--					
(Mil. BGN)	2021	2022	2023e	2024bc	2025bc	2026bc
Operating revenues	1,626	1,902	2,159	2,320	2,507	2,714
Operating expenditures	1,429	1,650	1,982	2,140	2,311	2,492
Operating balance	197	252	178	179	196	223
Operating balance (% of operating revenues)	12.1	13.2	8.2	7.7	7.8	8.2
Capital revenues	22	45	116	123	89	97
Capital expenditures	167	257	310	323	337	331
Balance after capital accounts	52	40	(16)	(20)	(51)	(12)
Balance after capital accounts (% of total revenues)	3.1	2.0	(0.7)	(0.8)	(2.0)	(0.4)
Debt repaid	37	36	35	35	38	42
Gross borrowings	0	35	59	110	100	100
Balance after borrowings	51	102	(131)	55	10	47
Direct debt (outstanding at year-end)	650	639	655	730	791	849
Direct debt (% of operating revenues)	40.0	33.6	30.3	31.5	31.6	31.3
Tax-supported debt (outstanding at year-end)	903	847	805	861	914	959
Tax-supported debt (% of consolidated operating revenues)	46.7	38.0	32.1	32.0	31.7	31.0
Interest (% of operating revenues)	1.0	0.8	0.7	0.7	0.9	0.9
Local GDP per capita (single units)	45,241	55,808	62,634	67,512	71,032	74,918
National GDP per capita (single units)	20,094	24,537	27,629	29,991	31,777	33,751

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

City of Sofia--Ratings Score Snapshot

Key rating factors	
Institutional framework	4
Economy	3

Table 2

City of Sofia--Ratings Score Snapshot (cont.)

Financial management	4
Budgetary perfomance	3
Liquidity	1
Debt burden	3
Stand-alone credit profile	bbb
Issuer credit rating	BBB

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

Sovereign Risk Indicators, Dec. 11, 2023. An interactive version is available at www.spratings.com/sri.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., Dec. 15, 2023
- Bulgaria Outlook Revised To Positive From Stable On Prospects Of Eurozone Accession; 'BBB/A-2' Ratings Affirmed, Nov. 24, 2023
- Sofia's New Leadership Could Shift Policy, Although Structural Constraints Exist, Nov. 9, 2023
- Institutional Framework Assessment: Bulgarian Municipalities, Feb. 20, 2023

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Outlook Action; Ratings Affirmed

	To	From
Sofia (City of)		
Issuer Credit Rating	BBB/Positive/--	BBB/Stable/--