

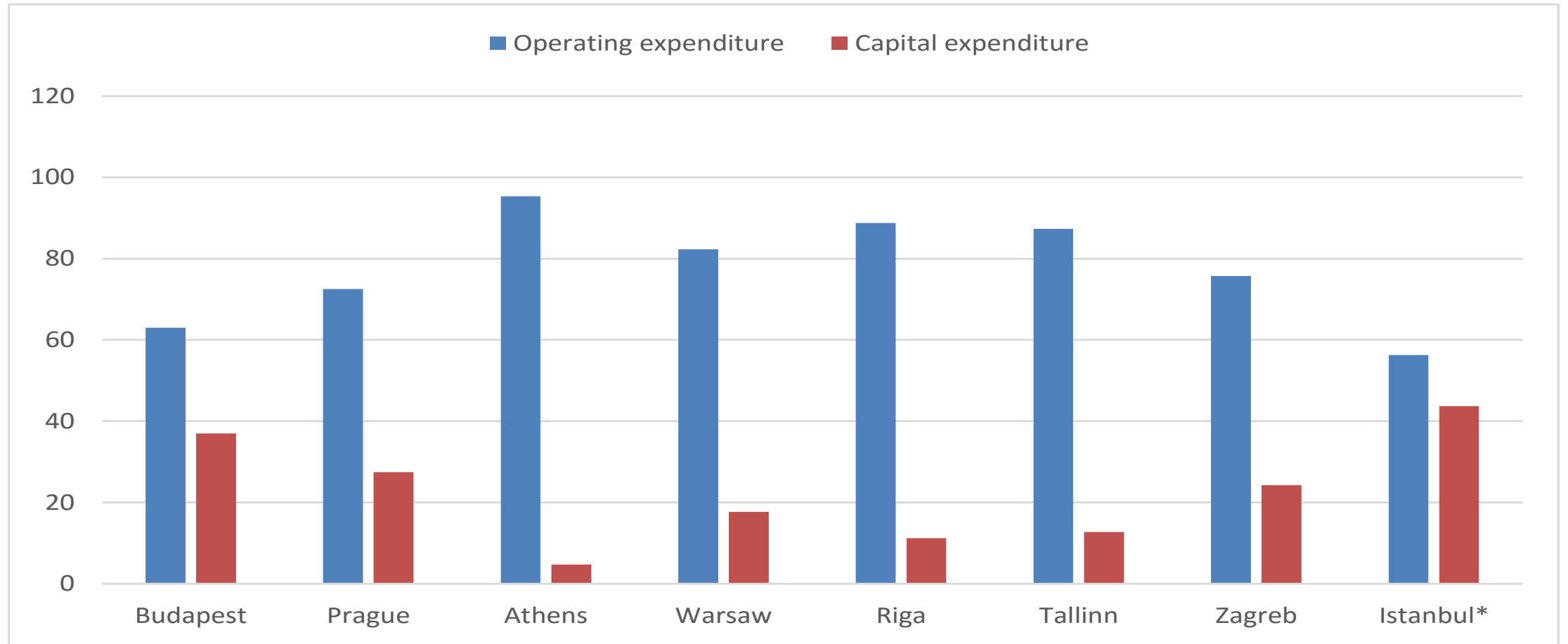
# Investment Planning and Funding

Case Study of Zagreb

# General remarks

- Devolution of competences and highly depreciated assets led to increased service provision and infrastructure demands
- As local governments are devolved greater level of educational and social responsibilities in recent past, current expenditure have an increasing weight on the budget
- Growth in own-source revenue is not sufficient to cover increasing investment needs
- Loans and bonds issue are becoming an important sources of infrastructure funding
- Additional sources of funding: Public Private Partnership, Leasing, EU funds, assets sale

# Expenditure structure of selected capital cities in CEE (year-end 2014)



Source: cities' data, author's calculation

# Investment funding – Case of Zagreb (2)

- In January 2007 the City of Zagreb combined its companies utilities under Zagrebacki Holding (ZH) in order to realize operational and cost efficiencies through a centralized organizational framework
- The ZH comprises 15 branches; holds majority stakes in nine subsidiary companies and one public institution
- Key businesses: (i) water supply and sewage; (ii) gas supply; (iii) public transport services; (iv) waste collection and recycling; and (v) road maintenance
- Overall strategy is based on investments and the reconstruction of infrastructure that ZH manages on behalf of the city
- Aggressive investment programme pursued in relatively short timeframe 2007-2010
- Bullet bonds issue of EUR300 million due in 2017

# Investment funding – Case of Zagreb

- The quasi-monopolistic positions of Zagrebacki Holding's key businesses make them vitally important for the Zagreb's utility sector
- The five key companies serve around 1,1 million inhabitants in the City and County of Zagreb
- The five key businesses together account for approximately 70% of the holding's company total revenue and EBITDA
- Of these, the public transport and gas & water utilities together account for about 50% of the Holding's total revenue and 40% of EBITDA

# Tariff regulation of the Holding key businesses

- Tariffs for key businesses in the Holding are regulated by the City, except for the Gas Company. The latter used to be under the City's regulation authority, but now falls under the tariff regulation by National Gas regulator.
- The City provides beneficial regulation regime for the companies, the tariff adjustments are not necessary regular to ensure stable profitability every year and tariff setting policy depends on the affordability prices for utilities and public transport

# City's commitment to support the development of key businesses

The Holding highly benefits from the close involvement of the City of Zagreb in its development through enjoying City's direct contributions to:

1. The operating activities and contribution to the debt repayment of selected companies
2. Investment programs of its branches
3. Its guarantees
4. Liquidity facility from the City

# The City of Zagreb undertook a large investment programme through the Holding

- The city's infrastructure systems e.g. for public transport or the water supply and sewage networks, were relatively old and in need of repair, modernization and renewal when the Holding was founded
- In particular, *Transport company's* vehicles were relatively old with an approximate average age of 25 years for its tram fleet and of 10 years for its bus fleet
- *Water Company* had water supply network infrastructure on average 40 years old with pipes leakages as high as 45%, which it targeted to reduce it to 18% by 2015.
- Its sewage system was old and in bad condition, which potentially led to environmental liabilities and a potential ecological impact on underground waters



# The City of Zagreb undertook a large investment programme through the Holding (2)

- *Waste collection* company aimed at reducing the average age of its vehicles from 11.5 to 7 years
- *Gas* expected to expand and renew extensive parts of the network and enhance its safety and reliability; and
- *Road maintenance* planned to invest in its vehicle fleet of trucks, rollers and finishers for expansion

# The City of Zagreb undertook a large investment programme through the Holding (3)

- Between 2007 and 2010 the Holding investment plan amounted to about HRK4.8 billion (apr. EUR650 million) primarily to improve public transport, gas distribution, water supply and sewage systems
- About 17% of this amount was funded by the City of Zagreb
- Apart from that Water company investment plan started in 2008 and projected to complete in 2019 will consume additional HRK5.6 billion, of which about HRK2.9 billion related to the sewage system

# Sources for investment funding

- In 2007 the holding company issued EUR300 million senior unsecured bullet bond on the international market with 10 years maturity
- The proceeds from bond were used to pre-fund a substantial proportion of the capex programme between 2007 and 2010
- The City has not committed to funding a sinking fund for any substantial maturities
- The Holding is attempting to refinance these obligations due in 2017
- The remainder of the capex programme was financed from 1) the City's budget, 2) the remaining companies financed their investment needs through their own resources or new loans/leasing contracts

# Close linkages between the City and the Holding

## **STRENGTHS**

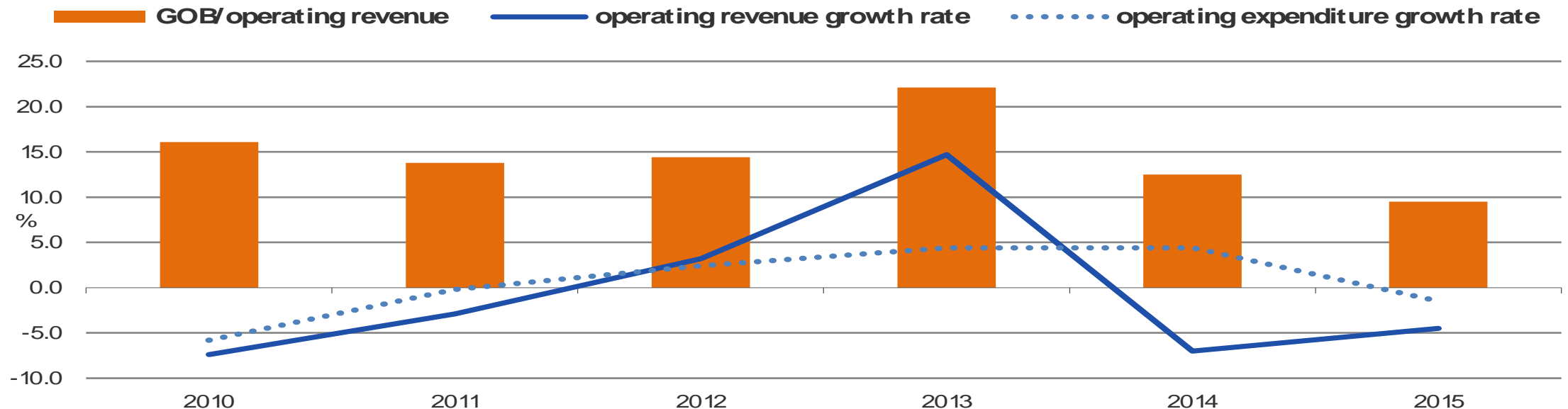
- Strong controls over the management and spending plans of ZH either in the form of transfers or regulated tariffs
- The City's commitment to and track record of supporting the operating activities and investment programmes of ZH's non-self-supporting businesses
- Predictable cash flows from low business risk and regulated environment
- ZH's investment programme may provide significant value for the company's assets, which may be available for mitigation of debt and/or future capital expansion

## **WEAKNESSES**

- Prices for the services are capped by strong social constraints
- Efficiencies from cost-cutting and rationalisation have begun to be realised and have yet to materialise
- Dependence on Zagreb's subsidies
- High debt burden accompanied with significant foreign currency risk exposure

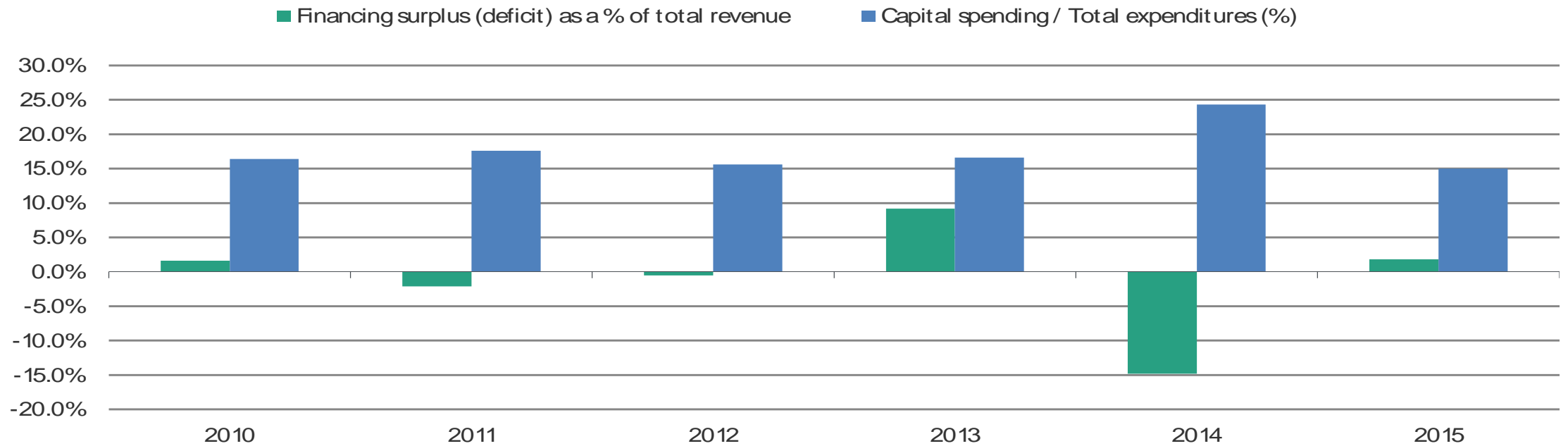
# Operating performance of the City of Zagreb

- Gross operating balance declined at around 10% of operating revenue from 15% on average during 2010-14
- Lower proceeds from PIT, which represent 72% of the city's total operating revenue
- Cost control to keep operating margins at current levels



# Financial performance

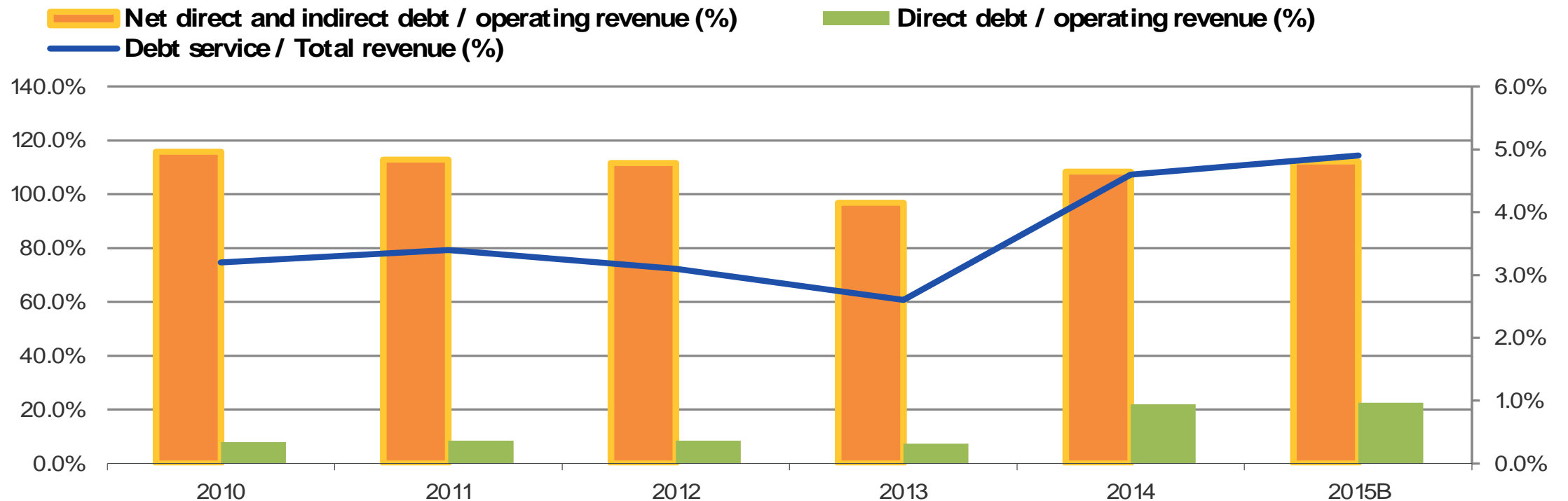
- Financing results deteriorated in 2014 due to increased capital spending
- Solid operating margins combined with prudent cash flow and decline in capex imply good self-financing capacity of the city
- Financing results, linked with capital investment, returned into positive territory



Source: City of Zagreb, author's calculation

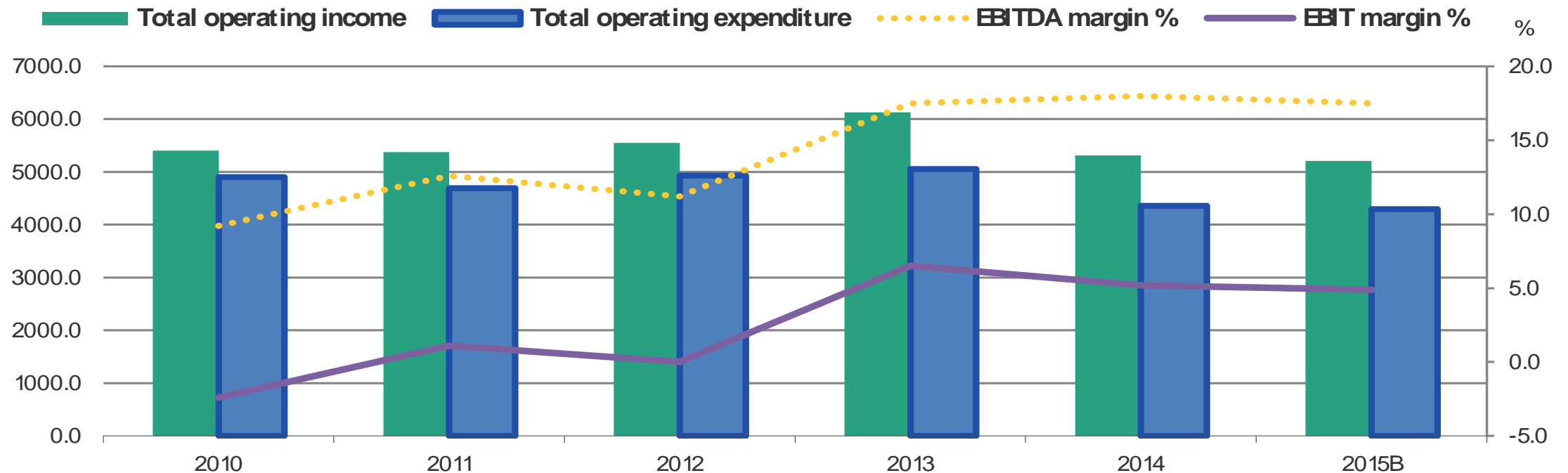
# Debt profile of the City of Zagreb

- Low direct debt levels
- Net direct and indirect debt remaining at high levels of about 112% of operating revenue
- Debt service at manageable levels of 5% of operating revenue



# Zagrebacki Holding's performance

- Satisfactory financial performance
- Ongoing restructuring programme has thus far resulted in improved financial position
- Improved liquidity profile
- Declining, but still sizeable debt burden



Source: Zagrebacki Holding, author's calculation



# EU capital transfers will represent a valuable funding source for Zagreb's projects beyond 2015

- New EU membership opens up significant opportunities for Croatian RLGs including the City of Zagreb to access the EU Cohesion and Structural Funds within the new financial framework 2014-2020
- Croatia is scheduled to receive EUR13.7 billion from these funds
- EU capital transfers for the 2014-2020 programming period will support RLGs' efforts to:
  - 1) expand infrastructure investment and thus stimulating local economic development and boosting long-term economic growth
  - 2) Diminish RLGs' need to recourse to debt financing of their investments
  - 3) Push RLGs to increase their expertise to prepare, plan, and implement complex, multiyear investment plans and make prudent use of available funds.

Thank you!