Credit Rating Report | Local and Regional Government| August 2023

City of Johannesburg Metropolitan Municipality

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook / Watch
City of Johannesburg Metropolitan Municipality	Long Term issuer	National	A(ZA)	Negative Outlook
	Short Term issuer	National	A1(ZA)	

Analytical entity

City of Johannesburg Metropolitan Municipality (CoJ or the metro) is one of the 3 category A municipalities in the Gauteng province of South Africa. It covers around 1,645km² of the province's 9,918km² domain, housing the largest population and being the centre of South Africa's economy. The metro consists of seven regions, of which some of the main areas which are Midrand, Sandton, Roodepoort, Soweto, Alexandra, Inner City (central Johannesburg) and Orange Farm.

Credit profile summary

Strengths

- Regarded as the economic hub of South Africa, being the home to many large national and international companies, across a diverse range of economic activity
- Well diversified internally generated revenue base with low reliance on grant funding
- Continues to demonstrate some access to debt funding
- Ability to maintain a balanced budget with a positive operating surplus (albeit reducing)

Weaknesses

- High and consistently increasing levels of Unauthorised Irregular Fruitless and Wasteful Expenditure
- Ongoing political instability, with frequent changes in mayoral leadership
- High gearing with moderately weak credit protection metrics
- Lower debtor collection has led to reduced cash flows and weaker service delivery
- Lower rate of capex implementation will exacerbate CoJ's infrastructure backlog

Rating summary

The rating downgrade and Negative Outlook for City of Johannesburg Metropolitan Municipality (CoJ or the metro) reflects ongoing pressures on operating performance evidenced in subdued income growth, increasing expenditures and relatively weak collection rates. The income constraints have translated into deteriorating credit protection metrics and tighter liquidity. This continues to restrict the ratings, notwithstanding the metro's position as the economic center of South Africa.

Outlook statement

The Negative Outlook reflects GCR's opinion that operating performance will remain weak, with significant risks to CoJ achieving its turnaround initiatives in the short to medium term. In this regard, improving collections is likely to be challenging amidst the current economic environment, which combined with rising inflation, ongoing load shedding and wage pressures, could see the liquidity position worsen. Political instability also presents a major risk to implementation of turnaround plans.

Rating triggers

CoJ's rating could be further downgraded if its operating performance does not meaningfully improve. Factors in this regard include: 1) weak collection rates below 90% that impedes the liquidity position; 2) declining spend on capex and maintenance; 3) ballooning creditors payments; and 4) further weaknesses in governance controls.

In the shorter term, a return to a Stable Outlook depends on the metro's ability to stabilize its operating performance and liquidity reserves. This could derive through improved income growth and collections thereby driving stronger cash flows that allow for higher maintenance and capex spend.

Risk score summary

Rating components & factors	Risk Score
Operating environment	**13.75**
Country and sector risk score*	14.00
Adjustments	(0.25)
Business profile	**2.00**
Local and Regional Government Profile	3.00
Operating Performance	(0.50)
Management & governance	(0.50)
Financial profile	**(2.75)**
Leverage & capital structure	(1.50)
Liquidity	(1.25)
Comparative profile	**0.00**
Government Support	0.00
Peer analysis	0.00
Total risk score	**13.00**

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

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Related criteria and research

Criteria for the GCR Ratings Framework, January 2022
GCR Rating Scales Symbols and Definitions, May 2023
Criteria for Rating Local and Regional Governments, June 2019
GCR's Country Risk Scores, May 2023

Ratings history

City of Johannesburg Metropolitan Municipality					
Rating scale	Review	Rating class	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	AA(ZA)	Stable Outlook	October 2018
Short Term Issuer		National	A1+(ZA)		
Long Term Issuer	Last	National	A+(ZA)	Stable Outlook	July 2022
Short Term Issuer		National	A1(ZA)		

Operating environment

Country risk

The South African country risk score has been maintained at a '7.00', partially reflecting the rebound in GDP per capita to USD6970 at 2022 from USD5660 at 2020 due to exchange rate improvements. Modest growth, alongside the persistent inflation pressures and high and rising unemployment (32.7% at Q4 2022) are the most significant pressure points for the South Africa country risk score and raise the risk of possible social unrest and industrial action going forward. Government debt levels remain high, projected at 73.7% for 2024 from 70.7% in 2023 and the risks are exacerbated by the vulnerable financial positions of State-Owned Entities which will continue to require large amounts of capital. Positively, the mining boom has provided some relief for government revenues. However, weak macro-economic fundamentals and poor electricity generating capabilities have and are expected to continue to hamper growth prospects in the short to medium-term. The South African Reserve Bank's Monetary Policy Committee (January 2023) projected GDP growth of 0.3% for 2023 and 0.7% for 2024 - largely on account of electricity constraints.

Whilst the IMF project real GDP growth (October 2022) are 1.1% for 2023 and 1.3% for 2024. South Africa being placed under Increased Monitoring by the Financial Action Task Force (FATF) has increased reputational risk however, it is expected not to materially change the fiscus. The government is committed to resolve the eight remaining strategic deficiencies identified in the Mutual Evaluation (October 2021) and the subsequent assessment conducted in January 2023.

Given the before mentioned and its impacts on the ZAR that would apply further inflationary pressures with the risk of a technical recession ever likely over the next 12 to 24 months. The assessment is somewhat supported by stable institutional scores that are better than regional peers.

Details on the country risk score are outlined in GCR's Country Risk Score report, available at https://gcrratings.com/risk-scores/

Sector risk

GCR considers the South African municipal sector to demonstrate a strong institutional and legislative framework. The quality of financial reporting is robust in that municipalities are required to publish quarterly financial performance reports, as well as very detailed annual financial statements. There are also several oversight bodies, most notably the Auditor General, who audits the financial statements annually and provides detailed opinions as to compliance with the necessary financial and operational regulations.

However, the South African municipal sector is experiencing a number of financial and political challenges. Rates and service tariffs have been rising faster than inflation and are expected to see even sharper increases in 2023 and 2024 as Eskom implements high tariff increases. As such, residents have increasingly struggled to meet monthly payments to municipalities, resulting in weak debtors' collection rates. Financial institutions have also become much more reluctant to lend to municipalities, given their deteriorating financial position. These problems have been exacerbated by political instability within many municipalities, negatively impacting the various councils' ability to address short term challenges, as well as implement long term planning for financial sustainability.

As per GCR's criteria, the operating environment score is double the country risk score, whereafter some adjustments may be made. Given the current challenges in the South African municipal sector, a small negative adjustment has been made, which could be increased if the problems and instability persists.

Details on the Sector risk score are outlined in GCR's Sector Risk Score report, available at https://gcrratings.com/risk-scores/

Business profile

Local and regional government profile

CoJ is the economic hub of South Africa, contributing c.15% to the country's GDP. The metro is also considered to be an economic gateway to the African continent, being the base for many multinational companies' headquarters, and boasts a well-developed road and highway network that serves as a portal to national and international routes. Further, CoJ benefits from its diverse economy which continues to anchor its economic stability. Underpinned by a broad services sector, the metro provides economic and social opportunities to both South African citizens and migrants. Consequently, it has experienced population growth in 2022 of c.2.3%, ahead of c.0.8% of the country while hosting c.10% of the country's population.

Some 80% of the metro's income is internally generated revenue (IGR), of which electricity and water sales and income from property taxes are the key contributors. As a result the Metro is reliant on grants for only 19.5% of its income. CoJ's GDP growth during 2021 and 2022 registered above the national GDP, albeit that economic growth has been slowing for much of the past decade. As such, the growth evidenced has not been adequate to meet the demands of the increasing population amidst a high unemployment rate within the metro, which currently stands at 39.1% (2021: 40.8%), significantly higher than the national average of 29.8%. This burdens CoJ with additional social grant responsibilities for its residents, against more constrained income levels. 52.5% of the population is estimated to live below the poverty line (compared to c.62.6% nationally), but other socio-economic statistics such as access to electricity, sanitation, access to water and education exceed the national average.

Delays in capital expenditure rollouts, as well as in repairs and maintenance due to cash flow constraints, are likely to limit the metro's ability to sustain service delivery insofar as water, power and roads are concerned, where the infrastructure is worn out. That said, although GCR positively notes the metro's plans to prioritise infrastructure through a targeted capex spending plan of approximately ZAR24.4 billion over the next three-years, we acknowledge that this is largely dependent on its ability to improve collections and cash flows and access the requisite funding (ZAR2.5 billion in debt funding each year). Moreover the high unemployment rate and deterioration in service provision against the backdrop of a rapidly growing population remains a cause for concern and this could result in a moderation the LRG score going forward.

Operating performance

CoJ's operating performance worsened over financial year ended 30 June 2022 (financial 2022) on the back of persistent service delivery backlogs, load shedding and political disfunction. The metro reported income growth of just 2.5% for financial 2022 (financial 2021: 6.4%), falling 9% short of budget, underpinned predominantly by lower consumption of electricity and water, which fell 14% and 12% short of budget respectively. This as consumption patterns changed materially post-COVID-19 with many businesses now operating under hybrid working conditions, and both households and businesses shifting to renewable energy sources in the face of worsening load shedding. Coupled with increasing electricity and water losses (due to a combination of illegal connections, billing errors and persistent infrastructure challenges), which registered at 30% and 32% respectively (financial 2021: 29% and 25%), lower consumption against higher bulk purchases continue to squeeze margins. In this regard, the gross electricity margin decreased during financial 2022 to 18% (financial 2021: 21%), although CoJ had forecast an improvement to 27% for financial 2022, from prior average historical levels of around 22-24%. Pressure on gross water margin also saw this decreasing to 15% (financial 2021: 17%). Whilst property rates income evidenced a marginal increase at financial 2022, the City's implementation of the new General Valuation Roll from 1 July 2023 should see a more meaningful improvement in rates income during financial 2024.

Positively, the metro's internally generated revenues (IGR) are well diversified into property rates (23%), electricity (28%), water (13%), service revenue (14%) and other income (3%). GCR favourably views CoJ's limited reliance on government grants particularly in light of the constrained national fiscus which casts doubt on the reliability of grant income.

Exhibit 1: Income progression (ZARmillion)

	FY2018	FY2019	FY2020	FY2021	FY2022	%Δ FY2022	5yr CAGR
Rates	9 640	13 282	13 446	13 660	14 090	3.2	10.0
Electricity	13 210	13 956	15 412	15 569	17 109	9.9	6.7
Water	5 997	6 996	6 964	7 282	7 827	7.5	6.9
General service	5 618	6 356	7 106	8 050	8 640	7.3	11.4
Grants & subsidies	9 782	10 746	11 183	12 604	12 110	(3.9)	5.5
Other income	2 342	2 751	2 753	3 347	2 246	(32.9)	(1.0)
Total income	**46 588**	**54 086**	**56 864**	**60 511**	**62 023**	**2.5**	**7.4**

Source: AFS

Although containing expenses remains a key priority, expenditure grew by 6.5% during financial 2022, resulting in a substantial narrowing of the operating surplus to ZAR1.0 billion from the ZAR3.4 billion reported in financial 2021. Whilst growth in salaries and wages was well controlled at only 5.5%, this was a function of vacant positions not being filled during the year, which could also detrimentally impact service delivery going forward. GCR anticipates that ongoing inflationary pressures coupled with the steep increases in bulk service costs will likely see growth in expenses continue to surpass revenue growth, thus constraining the ability of the metro to maintain its surpluses.

Exhibit 2: Expenditure progression (ZARmillion)

	FY2018	FY2019	FY2020	FY2021	FY2022	%Δ FY2022	5yr CAGR
Salaries and wages	10 841	12 740	14 527	15 437	16 291	5.5	10.7
Electricity	10 350	10 915	11 640	12 260	14 023	14.4	7.9
Water	4 823	5 621	6 041	6 090	6 639	9.0	8.3
Grants & donations	289	180	289	38	138	261.4	(16.9)
Depreciation	3 133	3 251	3 366	3 859	3 751	(2.8)	4.6
Contracted Services	39	33	41	50	123	146.5	33.0

Repairs & maintenance.	1 946	2 324	2 478	2 775	3 339	20.3	14.4
Other expenses	7 056	6 401	6 858	8 019	8 755	9.2	5.5
Bad debts	3 483	4 652	7 014	6 667	5 907	(11.4)	14.1
Net interest	2 525	2 500	2 524	2 607	2 621	(7.5)	0.9
Total expenditure	**44 486**	**48 616**	**54 777**	**57 801**	**61 587**	**6.5**	**8.5**

Source: AFS

The weaker cash flows are already evident in the still low repairs and maintenance spend (which registered at 5% of total expenditure, below the National Treasury guideline of 8%), as well as reduced capex. Capex for financial 2022 was recorded at ZAR6.6 billion (financial 2021: ZAR6.8 billion), with a slightly lower ZAR6.5 billion now expected for financial 2023. Whilst the metro expects to regain momentum from financial 2024 in line with its 3-year ZAR24.4 billion capex program, GCR is concerned that declining cash flows coupled with challenges in securing funding, could hinder CoJ's success in this regard. We consider this to be a key longer-term risk as to the extent that adequate capex and repairs and maintenance are not completed, service delivery cannot improve.

Exhibit 3: Operating Surplus analysis (ZARmillion)

	FY2018	FY2019	FY2020	FY2021	FY2022
Income	46 588	54 086	56 864	60 511	62 023
Expenditure	(41 961)	(46 116)	(52 253)	(55 195)	(58 966)
Op. surplus	**4 628**	**7 970)**	**4 611**	**5 316**	**3 057**
Interest	(1 843)	(1 748	(1 840)	(1,960)	(2 023)
Net surplus	**2 784**	**6 223**	**2 772**	**3 356**	**1 034**

Much of CoJ's financial problems appear to emanate from the rising debtors' book. Gross consumer debtors increased sharply to a record high of ZAR46.2 billion at financial 2022 (financial 2021: ZAR40.0 billion) – more than double the amount recorded in financial 2018 of ZAR21.7 billion. Moreover, as residents and commercial property owners continue to face affordability pressures amidst the increasing inflationary and interest rate environment, the average collection rate fell to 87.7% at financial 2022 (financial 2021: 90.2%), despite the enforcement of enhanced collection measures over the review period that were expected to see an improvement in the collection rate to 92.0-93.0%. Little recovery in the collection rate is expected over the next 3 financial years (financial 2023 to financial 2025), with the metro forecasting average collection rates of only around 88% (historically, collection rates exceeded 90%). This as revenue collection challenges and higher indigent residents will to constrain income. Overall, GCR anticipates cash flow from operations to remain under pressure over the rating horizon unless there is a meaningful improvement in overall national economic growth.

Exhibit 4: Cashflow (ZAR'm)

	FY2018	FY2019	FY2020	FY2021	FY2022
Cash flow from operations	4 894.7	8 548.4	5 739.4	6 048.8	4 066.3
Net capital expenditure	(6 497.6)	(7 397.1)	(5 309.3)	(6 782.5)	(6 620.7)
Investment activity	959.5	(9.4)	0.9	574.4	(269.0)
Retained cash	**(643.4)**	**1,142.0**	**431.0**	**(159.3)**	**(2 823.4)**

Source: AFS

Management and governance

CoJ has received unqualified audit reports for the last 10 years, albeit that some municipal entities have deteriorated from previous Clean Audits. The majority of the findings relate to non-compliance with the Municipal Finance Management Act (MFMA) on procurement and tender management, leading to an increased in unauthorised, irregular, fruitless and wasteful expenditure (UIFWE) to a cumulative ZAR20.8 billion at financial 2022 (financial 2022: restated to ZAR17.6 billion). Whilst the metro's various policies and procedures to reduce and investigate such expenditure are noted, these have had little impact on the outcome over recent years. At the same time, CoJ has faced ongoing political instability, with frequent changes in mayoral leadership, which we view as a governance weakness.

Financial profile

Leverage and capital structure

CoJ's financial position remains constrained by its high gearing, with gross debt increasing to ZAR24.0bn at financial 2022 (financial 2021: ZAR23.6 billion). Coupled with a decrease in cash reserves, net debt increased materially to ZAR17.7 billion (financial 2021: ZAR14.6 billion), translating into weaker credit protection metrics at financial 2022. Operating cashflow coverage of gross debt reduced notably to 17.0% (financial 2021: 25.6%), as operating cash flow fell to ZAR4.1 billion (financial 2021: ZAR6.0 billion). Similarly, interest coverage registered at a lower 2.3x (financial 2021: 3.0x). CoJ has confirmed that all financial 2023 debt obligations were met timeously and accordingly gross debt reduced to c.ZAR22 billion at 30 June 2023.

Exhibit 5: Leverage progression

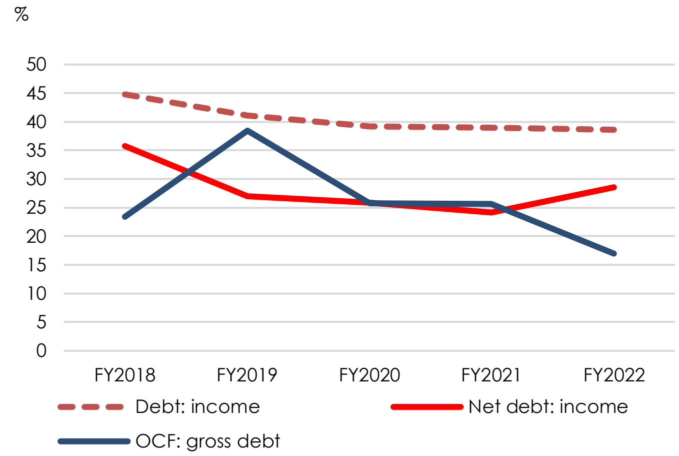
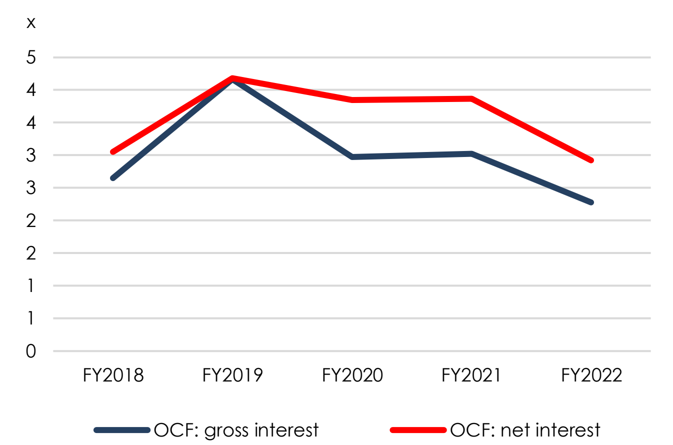


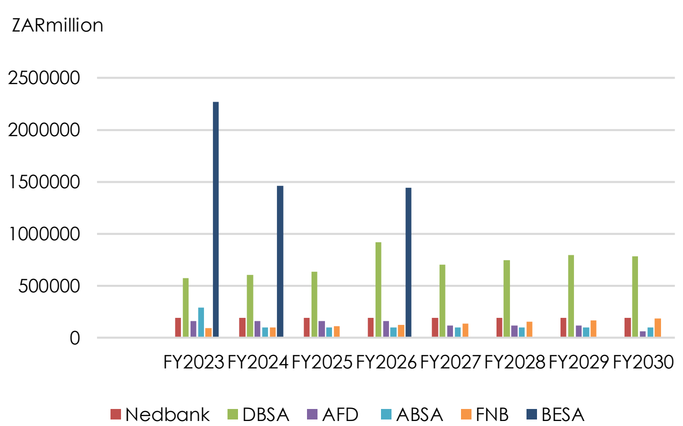
Exhibit 6: Interest Coverage



Although debt levels are expected to remain relatively stable in the short term, GCR does not expect improvements in the leverage metrics at financial 2023 given the persistent strain on income and cash flow. Further, although the metro has demonstrated some access to capital, as evidenced by new funding lines received from FNB during financial 2022, and from DBSA and IFC during financial 2023, GCR remains cognisant of the limited appetite of most other commercial funders. In this regard, future funding to CoJ from the Development Bank of South Africa (DBSA) could be limited due to restrictions in counterparty limits, with DBSA currently providing some 52% of CoJ's total debt.

Exhibit 7: Debt Maturity Profile

Exhibit 8: Debt Maturity Profile by Lender



CoJ's well-laddered debt maturity profile is positively considered, with the bulk of the obligations amortising in nature. Only the DMTN notes have bullet repayments, but the redemption is managed by quarterly investments into a sinking fund account which was valued at ZAR1.1 billion at 30 June 2023 (post financial 2023 redemptions). Of concern, however, is the shorter tenor of new debt facilities, with most amortising over a ten-year period, compared to periods of 15 to 25 years previous.

Liquidity

The metro's liquidity position continues to worsen, evidenced by the reduction in unencumbered cash on hand from ZAR6.6 billion at financial 2021 to ZAR3.8 billion at financial 2022. Despite the slower implementation of capital projects, GCR expects CoJ's cash balance to reduce further to c.ZAR3.2 billion at 30 June 2023 on the back of still low collections, with cash days on hand reducing to 32 days (financial 2022: 44 days). Although the metro forecasts sufficient available liquidity for financial 2024, with the sinking fund available to meet the bond maturity of c.ZAR1.5 billion due in June 2024, debt amortization payments in an amount of c.ZAR1 billion as well as unfunded capex of ZAR4.4 billion will need to met through internally generated cash. Additionally, whilst GCR notes CoJ's efforts to address its large outstanding creditors' balance, we expect this to remain higher than historical levels.

Comparative profile

Peer analysis

No peer adjustments have been factored into the ratings.

Group support

Group support is not applicable to the ratings.

Rating adjustment factors

Structural adjustments

No Rating Adjustment Factors have been factored into the ratings.

Instrument ratings

No adjustments for instrument ratings are applicable.

Glossary

Asset	A resource with economic value that a company owns or controls with the expectation that it will provide future benefit.
Capital	The sum of money that is invested to generate proceeds.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
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.
Diversification	Spreading risk by constructing a portfolio that contains different exposures whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given 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.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.

Salient Points of Accorded Ratings

GCR affirms that a.) no part of the rating 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.

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The rated entities participated in the rating process via face-to-face management meetings, as well as other written correspondence. Furthermore, the quality of information received was considered 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:

- Audited financial results to 30 June 2022 (plus four years of comparative numbers)
- Auditor General Report in respect of the financial year ended 30 June 2022
- Capital Expenditure schedule
- Schedule A accounts Budget report 2023/2024
- CoJ Presentations.

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