

Global Credit Research - 11 May 2011

South Africa

Ratings

Category	Moody's Rating
Outlook	Stable
NSR Issuer Rating -Dom Curr	A3.za

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Key Indicators

Swartland, Municipality of

	2006	2007	2008	2009	2010
Net direct and indirect debt/Operating revenue (%)	17.8	15.1	10.9	28.4	24.7
Interest Payments/Operating Revenue (%)	2.3	2.0	1.5	2.2	2.7
Gross Operating Balance/Operating Revenue (%)	7.7	15.1	28.2	13.6	-5.9
Cash Financing Surplus (Requirement)/Total Revenue (%)	8.4	-1.1	13.4	7.2	-2.0
Intergovernmental Transfer/Operating Revenue (%)	6.1	6.9	5.0	5.9	5.9
Real GDP (% change) [1]	5.9	6.3	4.3	-1.5	3.0
GDP per capita as % of National Average	145.2	143.8	132.0	129.2	133.3

[1] GDP at provincial level.

Opinion

SUMMARY RATING RATIONALE

The A3.za issuer rating of Swartland Local Municipality reflects its sound budgetary results, notwithstanding the small budget volumes. Thus far, its conservative financial management favoured the consolidation of a robust liquidity position and control of debt levels, which are regarded as moderate. Going forward, however, capital expenditure pressure will lead to use of accumulated cash and a manageable increase in debt levels. The rating also considers its narrow albeit relatively wealthy economic base.

National Peer Comparison

Swartland is rated in the mid-range of the 17 local municipalities rated by Moody's in South Africa, whose ratings span from A1.za to Baa2.za. Swartland's relative position reflects gross operating balances and debt levels that are in line with the median of its national peers. Swartland features small budget volumes compared to rated peers, reflecting its narrow dimensions.

Credit Strengths

Credit strengths for Swartland Municipality include:

- Sound financial position, despite the small budget volumes
- Robust liquidity position
- Sound financial management and budgetary control

Credit Challenges

Credit challenges for Swartland Municipality include:

- Growing debt burden, albeit still moderate

- Expenditure pressure for maintenance of ageing infrastructure and for new capital investments
- Narrow, albeit relatively wealthy, economic base

Rating Outlook

The rating outlook is stable.

What Could Change the Rating - Up

A rating upgrade is regarded as unlikely in the near future.

What Could Change the Rating - Down

Although unlikely in the medium term, deterioration in fiscal discipline, declining intergovernmental revenue and higher-than-anticipated reliance on debt financing could apply downward pressure on Swartland's rating.

DETAILED RATING CONSIDERATIONS

The rating assigned to Swartland Municipality reflects the application of Moody's Joint-Default Analysis (JDA) rating methodology for regional and local governments (RLGs). In accordance with this methodology, Moody's first establishes the baseline credit assessment (BCA) for the municipality and then considers the likelihood of support coming from the national government to avoid a default by the jurisdiction, should this extreme situation ever occur.

Baseline Credit Assessment

Swartland's BCA of 10 (on a scale of 1-21, where 1 represents the lowest credit risk) reflects the following factors:

Financial Position and Performance

Based on revenue of ZAR325 million in FY2010, Swartland is one of the smaller local municipalities rated by Moody's in South Africa. Swartland features a flexible budgetary structure, with 94% of operating income comprising own-source revenues - namely property tax income and service charges - and only 6% consisting of grant transfers from national government. Its revenue structure dominated by own-source revenue is expected to remain unaltered in the near future and allows Swartland to benefit from its relatively wealthy economic base. Revenue collection over the last five years has been consistently above 90%. On the expenditure side flexibility is limited and non-discretionary expenditures such as employee costs and bulk purchases represent a high 59% of operating expenditures. Furthermore unfunded mandates such as library services exact pressure on the municipality's operating expenses.

A dynamic revenue base combined with an efficient management of rigid operating expenditure components and a prudent approach towards capital investments has allowed Swartland to consolidate robust budgetary results, as reflected by the average financing surplus of 12% against operating revenue in 2005-10. In this regard, we note that the moderate operating deficit registered in 2010 was due to contingent reasons namely; a once off payment to Eskom of ZAR15 million and the unbundling of assets in terms of GRAP 17 that are unlikely to affect future financial results. Over the years Swartland preserved comfortable cash reserves and limited recourse to new debt. The municipality has over the years displayed a sound liquidity position with no usage of overdraft facilities. Going forward, the city is expected to access its cash reserves to contribute to the financing of its capital expenditure programme.

Debt Profile

After having increased substantially in FY2009 due to a new borrowing of ZAR45 million Swartland's debt stock stabilised at around ZAR68 million or a moderate 25% of the city's operating revenue at the end of FY2010. At the end of December 2010, municipal debt stock reduced to ZAR55 million. The overall debt exposure is in line with the similar sized rated municipalities and we believe that it is manageable. Going forward, we expect Swartland's debt-to-revenue ratio to increase moderately to around 30% by 2013, driven by the need to support the implementation its capital programme in a context of diminishing capital grants from the national government. New municipal borrowing will finance approximately 30% of the city's capital programme of R282 million in 2011-13.

Governance and Management Factors

Swartland demonstrates sound financial management and budget planning. The municipality's investment policies are in line with the Municipal Financial Management Act, thus reducing investment risk to low levels. Swartland consistently provides highly informative and comprehensive annual financial statements, including balance sheets, income statement and cash flow which are always independently audited by the Auditor General. The auditor's opinion has been consistently unqualified over the past four years, thus indicating prudent financial management and reporting.

Economic Fundamentals

Swartland is situated in the Western Cape Province, the second wealthiest province in South Africa. The province has an above average GDP per capita contributing 14% to national GDP in 2009 and has the lowest unemployment level in the country, at 22% in 2009. As mentioned above, Swartland's benefited from the favourable socio-economic conditions in Western Cape province.

Swartland Municipality covers an area of 3, 700 square kilometres and has a population of approximately 84,000 people spread across 11 towns. The municipality is located 60km west of Cape Town along N7 that links Cape Town with Namibia. Swartland is one of five local municipalities that form part of West Coast District and it is the second largest contributor to local gross value add (GVA) after Saldanha Bay, at 25%. Nonetheless, the local economy is relatively narrow and concentrated in manufacturing products such as steel works, wooden frames, pioneer food and bokomo, most of these products are exported outside the country. The West Coast district where Swartland is situated is well known for agricultural farming like wine farms, dairy farms, wheat products as well canola oil used for butter products, these products are also exported to other countries. Agriculture and manufacturing contribute 26% and 16% respectively to the local economy.

Operating Environment

The operating environment in which Swartland operates is characterised by moderate-to-low GDP per capita, relatively low GDP volatility and a moderate ranking on the World Bank's Government Effectiveness Index. These characteristics suggest a low level of systemic risk. The sovereign rating is currently A3, with a stable outlook.

South Africa's growth has been more resilient to the global crisis than many other countries at the same rating level, with a year-on-year GDP contraction for 2009 of only 1.8%. Moreover, the global financial crisis had only a modest direct impact on the domestic banking system due to a prudent regulatory environment and low levels of leverage. The recently published Medium-Term Budget Policy Statement (MTBPS) indicates a real GDP growth forecast of 3% for 2010, reflecting the economic rebound, and a surge in capital inflows. Notwithstanding the country's political transformation and socio-economic progress, South Africa has a multitude of challenges, including primarily high levels of poverty related to high rates of unemployment and under-employment, wide income disparities, and poor general education attainment. If inadequately addressed, these challenges could threaten the long-term economic and political stability of the country.

Institutional Framework

The institutional framework, which encompasses the arrangements determining intergovernmental relations and jurisdictional powers and responsibilities, features moderate financial predictability and stability. The municipal system in South Africa comprises six metropolitan municipalities (category A), 230 local municipalities (category B) and 47 district municipalities (category C). The administration system and associated policies are generally consistent and oriented towards enhancing accountability at the local levels; municipal oversight regarding budget approval and monitoring is performed by provincial governments, assisted by the National Treasury.

Spending responsibilities and revenue structures of South African municipalities are difficult to alter due to a consolidated legal framework. The high degree of revenue autonomy enjoyed by metros and large local municipalities - with transfers from the national government accounting for 5-20% of total revenue - compensates for the rigidity of their expenditure profile as a result of their statutory responsibilities (which are chiefly related to the delivery of basic services and municipal infrastructure). Conversely, district and small to medium-sized municipalities - whose primary role is to facilitate, fund and execute infrastructure development in the local municipalities within their jurisdiction - demonstrate moderate-to-high fiscal dependence on government grants. Municipal budgets are sensitive to economic cycles due to the nature of their own revenue sources, which include primarily property taxes and service charges for electricity, water, refuse and sewage. Municipalities are responsible for the collection of local taxes and charges and enjoy the discretion to set tax rates and tariffs. This allows for a moderate degree of revenue flexibility, particularly for metros and large municipalities.

The combination of fiscal transfers and own-source revenues at most metros and local municipalities has proved insufficient to provide the comprehensive range of services required. However, despite these pressures, municipal debt levels have generally remained low to moderate.

Extraordinary Support Considerations

Moody's assigns a low likelihood of extraordinary support from the South African government, reflecting, at the jurisdictional level, the national government's policy stance of promoting greater accountability for South African municipalities. Reputation risk for the central government is deemed modest, mainly in view of the heavy dominance of bank loans rather than bonds. The credit history of municipalities in South Africa also highlights past instances of missed payments or delinquencies on loans. Despite the new legal framework regulates the recovery of municipalities experiencing financial difficulties, it does not suggest timely extraordinary bail-out actions to avoid defaults on debt obligations.

Moody's also assigns a moderate level of default dependence between Swartland and the Republic of South Africa, reflecting a low reliance on national government transfers, its own sources of revenue distinct from those of the central government and the local economic base integrated with the national economy.

Output of the Baseline Credit Assessment Scorecard

In the case of Swartland Municipality, the BCA scorecard (presented below) generates an estimated BCA of 9, close to the BCA of 10 assigned by the rating committee.

The BCA scorecard, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, is a tool used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by the scorecard provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in the scorecard cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in August 2010 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Country Ceilings for Foreign Currency Obligations

Moody's assigns a ceiling for foreign-currency bonds and notes to every country (or separate monetary area) in which there are rated obligors. The ceiling generally indicates the highest rating that can be assigned to a foreign-currency denominated security issued by an entity subject to the monetary sovereignty of that country or area. In most cases, the ceiling will be equivalent to the rating that is (or would be) assigned to foreign-currency denominated bonds of the government. Ratings that pierce the country ceiling may be permitted, however, for foreign-currency

denominated securities benefiting from special characteristics that are judged to give them a lower risk of default than is indicated by the ceiling. Such characteristics may be intrinsic to the issuer and/or related to Moody's view regarding the government's likely policy actions during a foreign currency crisis.

Baseline Credit Assessment

Moody's baseline credit assessment incorporates the government's intrinsic credit strength and accounts for ongoing operating subsidies and transfers from the supporting government. In effect, the baseline credit assessment reflects the likelihood that a local government would require extraordinary support.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%), very high (71% - 95%) or fully supported (96% - 100%).

Default Dependence

Default dependence reflects the likelihood that the credit profiles of two obligors may be imperfectly correlated. Such imperfect correlation, if present, has important diversifying effects which can change the joint-default outcome. Intuitively, if two obligors' default risks are imperfectly correlated, the risk that they would simultaneously default is smaller than the risk of either defaulting on its own.

In the application of joint-default analysis to RLGs, default dependence reflects the tendency of the RLG and the supporting government to be jointly susceptible to adverse circumstances leading to defaults. Since the capacity of the higher-tier government to provide extraordinary support and prevent a default by an RLG is conditional on the solvency of both entities, the more highly dependent -- or correlated -- the two obligors' baseline default risks, the lower the benefits achieved from joint support. In most cases, the close economic links and/or overlapping tax bases and/or close intergovernmental fiscal arrangements between different levels of government result in a moderate to very high degree of default dependence.

Default dependence is described as either low (0% - 30%), moderate (31% - 50%), high (51% - 70%) or very high (71% - 100%).

Rating Factors

Swartland, Municipality of

Baseline Credit Assessment Scorecard - 2009	Value	Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weighting	Total
Factor 1: Operating Environment						
National GDP per capita (PPP basis, \$US)	10 267	15	50.0%	10.50	60.0%	6.30
National GDP Volatility (%)	2.4	3	25.0%			
National Govt Effectiveness Index (World Bank)	0.51	9	25.0%			
Factor 2: Institutional Framework						
Predictability, Stability, Responsiveness	7.5	7.5	50.0%	10.00	10.0%	1.00
Fiscal Flexibility (A): Own-Source Revenues	7.5	7.5	16.7%			
Fiscal Flexibility (B): Spending	15	15	16.7%			
Fiscal Flexibility (C): Extent of Borrowing	15	15	16.6%			
Factor 3: Financial Position & Performance						
Interest Payments/Operating Revenue (%)	2.0	1	25.0%	2.00	7.5%	0.15
Cash Financing Surplus(Req)/Total Revenue (%)	7.8	3	25.0%			
Gross Operating Balance/Operating Revenue (%)	18.0	3	25.0%			
Net Working Capital/Total Expenditures	59.6	1	25.0%			
Factor 4: Debt Profile						
Net Direct and Indirect Debt/Operating Revenue	28.4	1	50.0%	3.50	7.5%	0.26
Short-Term Direct Debt/Direct Debt (%)	11.0	3	25.0%			
Net Debt/Operating Revenue Trend	3.6	9	25.0%			
Factor 5: Governance & Management						
Fiscal Management	7.5	7.5	40.0%	5.00	7.5%	0.38
Investment & Debt Management	1	1	20.0%			
Transparency & Disclosure (A)	1	1	15.0%			
Transparency & Disclosure (B)	1	1	15.0%			
Institutional Capacity	15	15	10.0%			
Factor 6: Economic Fundamentals						
Regional or Local GDP pc PPP - estimated (\$US)	13 557	9	100.0%	9.00	7.5%	0.68
Estimated BCA						9

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