# Rating of Moravian-Silesian Region

Moravian-Silesian Region


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## RATING OF MORAVIAN-SILESIAN REGION

In June 2008, Moody´s Investors Service updated its ratings for the Moravian Silesian Region („MSR“).
The A2 long term issuer rating with stable outlook for the MSR reflects a Baseline Credit Assessment (BCA) of 7 on a scale of 1 - 21 (where 1 represents the lowest risk, 21 the highest). The BCA also reflects our assessment of the moderate likelihood that the national government of the Czech Republic would act to prevent a default by the region.
MSR's BCA of 7 reflects a number of factors, including generally prudent budgetary management mirrored in a manageable debt stock and the region's adequate operating performance and financial performance. The rating also takes into account the current institutional framework, the main features of which are limited spending flexibility and a heavy reliance on earmarked central government transfers. MSR's BCA of 7 reflects the following factors:

### Operating environment

The operating environment for Czech RLGs reflects that of OECD emerging market economies, with relatively high GDP per capita within the emerging markets universe, modest GDP volatility and relatively high ranking on the World Bank's Government Effectiveness Index. The combination of these characteristics suggests a low level of systemic risk, as reflected in the A1 rating assigned to the debt issued by the national government.

### Institutional Framework

The region, as part of the recently created (in 2001) layer of local governments in the Czech Republic, has experienced numerous changes in the size and composition of its budget. The fundamentals of the system related to the funding of regional responsibilities and their budget structure appear settled for the near future. From 2008, regional revenues will be influenced by the coalition government's reform programme, which involves a reduction in the overall tax burden in the Czech Republic, particularly with regard to lowering taxation rates for individuals and corporations. For 2008, the impact of the tax reform is anticipated to be offset by higher proceeds from VAT and the growth of the national economy.

## Financial Performance

Overall financial results have been solid. The region has carried out its responsibilities within available budgetary resources and, up to 2005, had not incurred any deficit or contracted any debt. MSR's budgetary results benefited from the financial reform introduced in 2005, which increased the regional share in the basket of shared taxes in exchange for a decrease in intergovernmental transfers. In 2007 the region's GOB peaked at 9.7 % of operating revenues. However, supported by the track record of the region's prudent budgetary policy based on conservative estimates of revenue and partial compensation by increased VAT, we retain our expectation that its operating margins should achieve at least current average levels in the medium term.

## Debt Profile and Cash

Although the region has resorted to debt in order to access EU funds, this is unlikely to create financial pressure going forward. MSR's stock of debt remains slightly below the regional average; current obligations should not represent a significant burden on the region's budget for the time being. In 2005 - 2008 the Region concluded a long-term loan with the EIB for co-financing the capital expenses related to these projects. The maximum repayment period is 25 years, but the region intends to repay the debt within 10 years. MSR has never had to resort to short term credit or overdraft facilities, as a result of the predictability and evenness of both its revenues and its expenditures. A potential need for additional investment financing in the form of bridge loans might occur beyond 2008. Moody's believes that the eventual amounts of debt drawn will remain appropriate in relation to MSR's rather limited debt repayment capacity.

## Governance and Management Factors

The region has a good track record of meeting its budgetary targets, helped by stabilised management and – in recent years sound national GDP growth. Prudent fiscal management is supported by comprehensive and transparent financial reporting, including two-year budget forecasts. Regarding debt management, however, Moody's considers MSR's experience to be limited, given the simple structure and moderate level of its debt.

## Economic Fundamentals

MSR accounted for about 10.5% of the Czech Republic's GDP, making it the second largest contributor after Prague. On a GDP per capita basis, the region ranks seventh in the national average. This moderate productivity and above average unemployment rates still reflect the historically industrial profile of the region (metallurgy and coal mining) and the deep transition. However, the recently booming economy reflects the ultimate impact on the local economy of the intense restructuring process. The automobile industry's role has especially increased with the arrival of Korean automobile manufacturer Hyundai. The company is situated in the recently developed industrial park at Nosovice and is expected to start operating by the end of 2008.

The following table presents an overview of the strong and weak points of MSR.

| Credit Strengths | Credit Challenges |
|---|---|
| generally prudent budgetary management, | limited revenue flexibility and capacity to generate independent sources of revenue combined with rigidity in operating expenditures constrains the region's debt repayment and investment capacity, |
| adequate operating performance, | a likely increase in debt and depletion of existing cash reserves as a result of the need to co-finance a heavy investment programme supported by EU funds, |

| Credit Strengths | Credit Challenges |
|---|---|
| good financial performance, | the potential impact on the revenue side of the recently implemented tax reform that will lower income taxes. |
| manageable debt stock. | |

From the point of view of the rating agency, the current rating could be enhanced by changes in the institutional framework, thereby enabling greater flexibility in income and expenses. However, such a change is not likely in the short-term. By contrast, a steep rise in indebtedness along with worsening management operating results would have a negative influence on the rating results from the point of view of the rating agency.

## Rating Outlook

According to the rating agency, a radical turn in existing MSK policy cannot be expected, particularly regarding the attitude towards indebtedness and budget management. This also holds true with regard to the regional elections, which take place in October 2008, during the course of which a change in the distribution of political power in the region might occur simultaneously with the modification of its strategic goals.

Over the medium term, the MSR's budget will be influenced by recently implemented reforms, effective 1 January 2008, particularly with regard to lowering taxation rates for individuals and corporations. In 2008 and 2009, any revenue losses arising from lower income tax rates are expected to be offset by higher proceeds from increased VAT and the growth of the national economy, underpinning the stable outlook.

MSR's finances will be significantly influenced by a substantial volume of investment subsidies expected during the EU's 2007 - 2013 programming period. Although income from the EU funds covers the majority of total project costs, they are usually received after the completion of particular investment actions. Thus, bridge loans are likely to be needed going forward, at least temporarily increasing the region's financial exposure. This area will continue to be monitored by the rating agency.