MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
20 May 2019

Rate this Research

RATINGS

Moravian-Silesian, Region of

Domicile	Czech Republic
Long Term Rating	A2
Type	LT Issuer Rating - Fgn Curr
Outlook	Positive

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Vojtech Zelezny +420.2.2410.6440
Analyst
vojtech.zelezny@moodys.com

Martin Pavlis +420.2.2410.6448
Associate Analyst
martin.pavlis@moodys.com

Massimo Visconti +39.02.9148.1124
VP-Sr Credit Officer/Manager
massimo.visconti@moodys.com

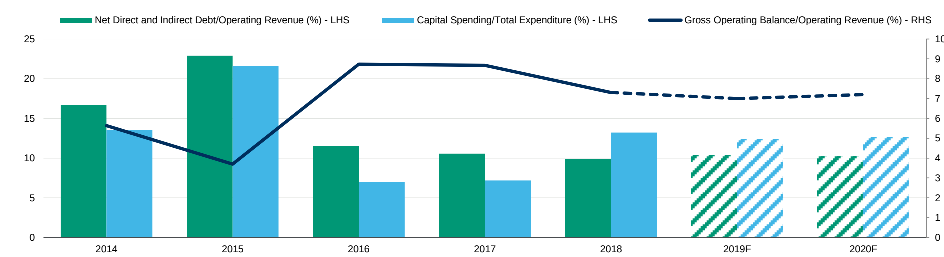
Region of Moravian-Silesian (Czech Republic)

Update to credit analysis

Summary

The credit profile of the Moravian-Silesian Region (MSR, A2 positive) reflects its low debt levels, solid operating performance and strong liquidity position, and a moderate likelihood that the Government of Czech Republic (A1 positive) would provide support if the region were to face acute liquidity stress. The region's solid operating performance is strongly linked to the growth of the national economy, while its good self-funding capacity is attributable to the MSR's prudent budgetary management. The MSR's rating is constrained by its high reliance on current transfers and shared taxes from the central government, but this is partially compensated by the stability of the Czech legislative environment.

Exhibit 1
Operating performance remains solid, while debt levels and capital spending tend to be stable in 2019-20



F - Forecast.
Source: Moravian-Silesian Region

Credit strengths

» Continued solid operating performance

» Debt levels to remain low in 2019-20

» High level of liquid reserves

Credit challenges

» Pressure on financial performance stemming from investment requirements

» Limited income and expense flexibility mitigated by stability

Rating outlook

The positive rating outlook reflects the improved sovereign environment, associated with the region's improving operating performance, low debt levels and comfortable cash reserves.

Factors that could lead to an upgrade

- » Upward pressure on the MSR's rating could arise from an upgrade of the sovereign rating.
- » Sustained improvement in the MSR's operating margin to higher double digits in percentage terms, along with contained debt levels, could lead to an upgrade.

Factors that could lead to a downgrade

- » Given the positive outlook on the sovereign bond rating, negative pressure is not expected.
- » A deterioration in the MSR's operating margin, combined with a reduction in liquidity and an increase in debt, would lead to downward pressure on the rating.

Key indicators

Exhibit 2

Region of Moravian-Silesian

	2014	2015	2016	2017	2018
Net Direct and Indirect Debt/Operating Revenue (%)	16.7	22.9	11.6	10.6	9.9
Interest Payments/Operating Revenue (%)	0.3	0.2	0.2	0.1	0.1
Gross Operating Balance/Operating Revenue (%)	5.6	3.7	8.7	8.7	7.3
Cash Financing Surplus (Requirement)/Total Revenue (%)	-0.2	-8.8	12.4	6.4	-0.3
Intergovernmental Transfers/Operating Revenue (%) [1]	98.7	98.7	99.1	99.1	99.0
Self-Financing Ratio	1.0	0.6	1.0	1.0	1.0
Capital Spending/Total Expenditure (%)	13.5	21.6	7.0	7.2	13.2

[1] Current intergovernmental revenue = current transfers + shared taxes.
Source: Moody's Investors Service

Detailed credit considerations

The credit profile of the MSR, as expressed in its A2 rating combines (1) a Baseline Credit Assessment (BCA) of a3, and (2) a moderate likelihood of extraordinary support from the national government in the event that the region faces acute liquidity stress.

Baseline Credit Assessment

Continued solid operating performance

In 2018, the MSR's operating revenue reached CZK22.6 billion, up 11.2% from that in 2017. The key drivers of this growth were the rise of central government operating transfers and proceeds from shared taxes, which were driven mainly by the growth of the economy of the Czech Republic. Personal income tax (PIT) increased by 13.5% in 2018 because of a rapid increase in salaries and wages in the national economy. The region recorded value-added tax (VAT) collection growth of 8% in the same year. On the contrary, corporate income tax (CIT) proceeds decreased by 2.3% from a year earlier.

The earmarked central government subsidies, linked to education and social care, rose by 13%, reaching CZK15.6 billion in 2018 compared with CZK13.8 billion in 2017.

The MSR's gross operating balance fell to 7.3% of operating revenue in 2018 from 8.7% in 2017 because of a rise in personnel and related costs in the public sector. We expect the MSR's operating margin to stabilize at around 7% of operating revenue in the next two years because of expected positive macroeconomic developments, with real GDP growth of 3.0% in 2019 and 2.5% in 2020. Ongoing restructuring of some regional hospitals will impose additional negative pressure on the region's budget.

Growth in operating expenditure surpassed that in operating revenue, rising by 12.8% in 2018 to reach CZK21 billion from CZK18.5 billion in 2017. Key operating expenditure elements that contributed to expenditure growth include increasing personnel costs, particularly in education, social services, culture, healthcare and transportation. We expect the annual growth in operating expenditure in 2019-20 to be constant, and we do not expect any significant pressure on the MSR's operating margin.

Debt levels will remain low in 2019-20

The region's net direct and indirect debt to operating revenue ratio further declined to 9.9% of operating revenue in 2018 from 10.6% in 2017. The MSR's direct debt (CZK2.1 billion) consisted of a loan of CZK1.7 billion with the European Investment Bank (EIB, Aaa stable) and a revolving credit line with Ceskoslovenska Obchodni Banka, a.s. (CSOB, A1 stable). The outstanding debt of a second EIB tranche (CZK110 million as of year-end 2017) was fully repaid in 2018. In 2019, the region opened a credit facility amounting up to CZK1 billion at UniCredit Bank Czech Republic and Slovakia, a.s.

Indirect debt, which is fully represented by the debt of regional hospitals (CZK197 million), accounts for 7.9% of net direct and indirect debt. We expect the debt levels not to change significantly in 2019 and hover around 10% of operating revenue. We expect the biggest project in the region's backlog (the modernization of Mosnov airport, amounting to CZK2.5 billion) to not be initiated in 2019. The region does not expect a substantial help from the central government and the European Union (EU, Aaa stable).

In 2018, debt service of the MSR increased to 3.5% of operating revenue from 1.2% in 2017. In 2019, we expect the cost of debt service to reach about 4% of operating revenue.

High level of liquidity reserves

The region's track record of solid financial performance has led to a comfortable liquidity position over the last few years. The accumulated cash strengthened in 2018, exceeding CZK3.7 billion, which is roughly equal to the level as of year-end 2017. This is equivalent to 16.4% of operating revenue in 2018. CZK1.8 billion was allocated in the region´s checking account, CZK970 million in region's fund accounts that are earmarked for specific purposes and CZK950 million was placed in savings accounts for value appreciation.

We expect the MSR's cash reserves to decrease slightly throughout 2019-20 as the region will partially use the available cash to co-fund the EU triggered capital investments and to repay its outstanding debt.

The MSR's current liquidity comfortably covers 3.6x its debt service requirements for 2019.

Pressure on financial performance stemming from investment requirements

The MSR's funding performance is strictly tied to its capital expenditures. The improving operating margin combined with the region's prudent cash management resulted in a strong self-financing capacity. In 2018, the region reached a low budget deficit of CZK62 million, equal to 0.3% of operating revenue.

In 2018, capital expenditures amounted to CZK3.2 billion, representing 13.2% of total expenditures, which is double the amount compared with CZK1.4 billion or 7.2% of total expenditures in 2017. The region's capital expenditures is dominated by transport, followed by environmental projects and education.

The regional administration's strategy on capex is closely linked with the use of available EU and central government capital funds. A certain level of uncertainty is brought by the new 2021-27 programming period because it will decrease the share of EU contribution funding to projects undertaken by the region. Furthermore, the applicable areas of investments are not set yet. In the current programming period, the contribution of EU subsidies amounted to half of the region's total capital expenditures.

The 2019 budget indicates an increase in capital expenditures to CZK3.4 billion. The MSR's capex within the VIZE 2024 programme envisages numerous extensive projects, focusing mostly on education, healthcare, transportation and social affairs. The most significant projects are the construction of a science library, a gallery of 21st-century art and a concert hall. These projects should be financed by a joint initiative of the MSR, the central government and the City of Ostrava (A1 positive). Although the planned increase in capital expenditures has the potential to weaken the region's financial performance and gradually deplete its cash reserves, we expect the

MSR's financial results to remain fairly balanced or contained at low-single-digit levels in percentage terms. Over the past few years, the MSR has had a proven solid track record in adjusting its capital spending to the current regional budget.

Limited revenue and expenditure flexibility mitigated by stability

The institutional framework for Czech regions features stable financial predictability and stability. However, the MSR has very limited control over its revenue base. The vast majority — 68.9% of the MSR's operating revenue in 2018 — stemmed from central government transfers in the form of earmarked grants for education and social services. Shared taxes, a national pool of VAT, PIT and CIT receipts, represented 30.3% of the region's operating revenue in 2018. The remainder is derived from nontax revenue, representing CZK188 million(not including incoming repayable help) or 0.8% of operating revenue.

This fiscal dependence on state resources exposes the region's finances to the performance of the central government budget and evolving intergovernmental relations. Regional governments' finances in the Czech Republic depend on the decisions of the central government, leaving the regional governments with no leeway with regard to taxes. We do not expect the composition of the MSR's operating revenue to change significantly in the medium term.

The spending flexibility of the MSR is also limited as more than 90% of its operating expenditure is made of highly inflexible expenses, including personnel costs, the purchase of goods and services, and transfers to the region's owned companies and institutions. Any room to maneuver would lie in cuts of some nonobligatory transfers. Capital spending remains a major leeway for the MSR, although it is curbed by high infrastructure needs, common for all Czech regional governments.

Extraordinary support considerations

We consider the MSR to have a moderate likelihood of extraordinary support from the central government, reflecting the central government's promotion of greater accountability for Czech regions. The system of oversight implemented by the central government requires regular monitoring of the regions' indebtedness and liquidity. Finally, reputational risk issues for the central government appear to be modest, given the regions' debt structure, which relies more on bank loans than on bonds.

Rating methodology and scorecard factors

The assigned BCA of a3 is in line with the scorecard-indicated BCA of a3. The matrix-generated BCA of a3 reflects (1) an Idiosyncratic Risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of A1, as reflected in the sovereign bond rating of the Czech Republic.

For details about our rating approach, please refer to Rating methodology: Regional and Local Governments, January 2018 (1091595).

Exhibit 3
Region of Moravian-Silesian
Regional and Local Governments

Rating Factors						
Moravian-Silesian, Region of						
Baseline Credit Assessment	**Score**	**Value**	**Sub-factor Weighting**	**Sub-factor Total**	**Factor Weighting**	**Total**
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	83.94	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	5	20%	1.00
Financial flexibility	9		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	7.90	12.5%	3.25	30%	0.98
Interest payments / operating revenues (%)	1	0.11	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	1	9.90	25%			
Short-term direct debt / total direct debt (%)	9	46.90	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**3.32(3)**
Systemic Risk Assessment						**A1**
Suggested BCA						**a3**

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
MORAVIAN-SILESIAN, REGION OF	
Outlook	Positive
Issuer Rating	A2

Source: Moody's Investors Service

REPORT NUMBER 1173498

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454