GCR GLOBAL CREDIT RATING CO.
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Buffalo City Metropolitan Municipality

South Africa Local Authority Analysis **November 2016**

Rating class	Rating scale	Rating	Rating outlook	Review date
Long term	National	$A_{(ZA)}$	Stable	November 2017
Short term	National	$A1_{(ZA)}$		

Financial data:

(USD'm comparative)

	30/06/15	30/06/16
R/USD (avg)	11.45	14.51
R/USD (close)	12.29	14.78
Total assets	1,272.2	1,155.5
Total debt	44.4	33.6
Total capital	1,122.6	1,006.8
Net debtors	56.5	70.0
Cash & equiv.	178.9	160.6
Total income	477.9	412.5
Net result	42.5	47.3
Op. cash flow	88.5	94.3
Net capex	(80.7)	(79.2)
Market cap.	Not listed	
Market share *	3.1%	

*Share of category A municipal income in F16.

Rating history:

Initial Rating (August 2003)
Long term: $BBB_{(ZA)}$
Short term: $A3_{(ZA)}$
Rating outlook: Stable

Last rating (May 2015)
Long-term: $A_{(ZA)}$
Short-term: $A1_{(ZA)}$
Rating outlook: Stable

Related methodologies/research:

GCR's Criteria for rating Public Entities, updated February 2016

Buffalo City Metropolitan Municipality ("BCMM") rating reports (2003 – 2015)

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Summary rating rationale

- BCMM's status as a metropolitan municipality since 2011 is positively considered given the greater operational freedom it offers, as well as the increased government support through grant funding. This has been demonstrated by the 13% CAGR in grant receipts since F11.
- BCMM has evidenced strong growth across all income items over the review period. Moreover, as expenditure growth has been below income, BCMM has recorded surpluses in each year under review, with the net surplus rising by 41% to R687m in F16.
- Of some concern, the electricity and water profit margins continue to contract, as rising bulk purchase costs cannot fully be passed on to consumers. However, forecast tariffs indicate that there should be some margin claw-back over the medium term through a programme put in place to reduce distribution losses.
- BCMM has a very strong liquidity profile, with total cash of R2.4bn at FYE16 (FYE15: R2.2bn). The build-up of cash has been a deliberate strategy to ensure sufficient resources for replacement capex and/or economic development projects. Thus, the metro has remained comfortably under geared over the review period.
- Gross debt decreased to a new low of R497m at FYE16 (FYE15: R546m). While gross debt to income declined to just 8% at FYE16. (FYE15: 10%). BCMM has, however, indicated that it may assume debt for specific development opportunities that have the potential to increase income to the metro.
- Although efforts to improve debtors collection are positively noted, with collections of current debtors exceeding 90%, BCMM's debtors book has continued to grow. Of concern is the persistence of debtors outstanding more than 120 days (69% of the total). While this has partly been driven by interest accrued on outstanding amounts, new debtors originated have also contributed to the relative increase. BCMM is seeking approval to write off historical debtors, in an effort to clean up and better manage the book.
- The Auditor General ("AG") again issued another "qualified" audit opinion on BCMM's F15 accounts, citing two issues, namely irregular expenditure and commitments. In addition, notwithstanding progress at improving compliance, amounts included under irregular expenditure remain relatively high.

Factors that could trigger a rating action include:

Positive change: Improving the audit outcome from the AG, would bode positively for the ratings. The successful implementation of ongoing operational projects that improve efficiencies and aid debtors collection would also be positively considered. In the medium term, an upgrade would also be dependent on capex projects that stimulate economic activity and employment growth, enhancing sources of income.

Negative change: Failure to adequately address infrastructure backlogs through capex would indicate that the cash resources are not being employed efficiently and will negatively impact on the ratings.

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Fundamentals

Buffalo City Metropolitan Municipality ("BCMM") is located in the Eastern Cape Province and includes East London, Bhisho and King Williams Town, as well as the townships of Mdantsane and Zwelitsha within the corridor of rural areas. This covers approximately 2,515km^2, with land usage spread between urban, peri-urban and rural, as well as commercial farming. Economically, the region is dominated by the motor industry, while agriculture and tourism form other important economic segments. BCMM became a metropolitan municipality in May 2011, giving it exclusive powers pertaining to building regulation, local tourism, parks and recreation, health services, public transport, cemeteries, beaches, water and sanitation, and general municipal planning.

Table 1: Select Census Statistics		2001	2011
Population (thousands)	BCMM	704.9	755.2
	EC	6,278.7	6,562.1
	RSA	44,819.8	51,770.6
Education - persons over 20 with matric (%)	BCMM	24.8	30.5
	EC	14.3	19.8
	RSA	20.4	28.4
Employment - official unemployment rate (%)	BCMM	53.1	35.1
	EC	41.6	29.8
	RSA	54.3	37.4
Housing - formal housing (%)	BCMM	62.9	72.5
	EC	51.5	63.2
	RSA	68.5	77.6
Housing - average household size (#)	BCMM	3.6	3.2
	EC	4.1	3.7
	RSA	3.8	3.4
Households with direct access to piped water (%)	BCMM	31.8	52.6
	EC	18.6	32.8
	RSA	32.5	46.3
Households with flush toilets (%)	BCMM	63.9	68.8
	EC	31.8	40.4
	RSA	50.0	57.0
Households with electricity for lighting (%)	BCMM	63.3	80.9
	EC	50.2	75.0
	RSA	70.2	84.7

Reflected in table 1 are selected socio-economic indicators from the 2001 and 2011 censuses, indicating improvements registered since the millennium and the back log of basic service delivery that is still being addressed. The Eastern Cape tends to lag South Africa as a whole in terms of human development, living standards and service delivery. In contrast, however, BCMM displays measures that are in line with or better than the country as a whole. This largely reflects its position as the economic hub of the region, where infrastructure is of a higher standard, and access to service is better. Nonetheless, the metro has been affected by the weak manufacturing environment, and thus has not been able to generate the necessary economic growth to allow it to address its social challenges efficiently. Given the development backlogs faced by BCMM and the high unemployment rate, revenue management is a key focus area for the municipality, as the expenditure required to address BCMM's challenges continues to exceed available funding. Positively, BCMM's service delivery commitments will take place within the confines of good management practice.

Critical to stimulating the economy is the East London Industrial Development Zone ("IDZ"), in which BCMM has a 27% stake. The IDZ's mandate is to ensure the creation of new jobs by attracting foreign direct investment. Thus, BCMM aims to enable an environment for the IDZ to operate in conditions that allow them to realise their strategy. This includes availing 870ha of land for projects. In addition, BCMM is actively supporting the large automotive sector by developing and maintaining infrastructure for the sector to operate efficiently. The metro has also been able to leverage opportunities associated with the expansion of the large Mercedes Benz SA ("MBSA") assembly plant.

In contrast, the non-automotive sector has been impacted more by the general economic challenges in the last five years, which have led to some factories closing down and material job losses. In this respect, BCMM is looking into incentives to attract new industries into the city and create sustainable jobs. Electricity incentives will be a core component, as it is the main cost of production. This also includes BCMM ensuring an enabling environment, in terms of transport networks (which are currently being upgraded) and ensuring the city is well run and stable.

To augment the management of BCMM, during F16 the municipality initiated the Integrated Property Information Management System ("IPIMS") which enables departments to fast track property applications as well as address the issue of deadlines and give updates. Property forms a basis of all municipal planning, engineering services, rates and billing and thus improving efficiencies is positively viewed. All systems will be linked to one integrated main system aimed at improving the overall quality of BCMM's information. The process is being handled by an appointed service provider.

In terms of expanding and improving the municipal areas, BCMM is following a dual approach. Projects that are designed to uplift poorer areas and provide infrastructure and services to indigents will largely be funded through government grants. BCMM will however, invest its own money in projects that can generate economic activity and income for the metro. These projects may not immediately generate direct revenue for the metro, but will attract businesses and residents that will pay higher rates and utilise more services.

BCMM currently has two major developments under consideration. The first is a new sanitation pipe north of the metro. This tunnel project will allow for the diversion of sewerage from the Central Waste Water Treatment Works to Reeston Waste Water Treatment Works, allowing for densification within the city. BCMM intends to borrow R436m to fund the project. The second development under consideration is the new government precinct in Bhisho. The funding model is still to be finalised, with the project cost estimated to amount to R1.4bn. The precinct is meant to consolidate Bhisho's status as the provincial political and administrative capital, with several provincial departments currently renting office space in East London and King Williams Town expected to relocate to Bhisho.

Administration

This rating report is based on the unaudited F16 financial statements of BCMM, upon which the AG has yet to opine. The Auditor General of South Africa ("AG") issued a qualified audit opinion for BCMM's consolidated financial statements for F15 (F14: qualified opinion). Key issues underpinning this opinion included:

- Irregular expenditure: understated by at least R156m, with poor systems rendering the AG unable to determine the full extent of the irregularity.
- Commitments: the AG found that the municipality did not accurately disclose all capex commitments. Specifically, PPE commitments were calculated using incorrect contract and payment values. In addition, certain capex expenditure contracts were excluded from the metro's list. Thus, commitments were overstated by at least R75m.

The AG also expressed emphasis of matter on the following:

- Impairments: the disclosed amount excluded bad debts written off relating to receivables from exchange transaction and non-exchange transactions totalling R151m.
- Material losses: in respect of water and electricity distribution, R99m (13% non- technical) and R163m (58% non-technical) respectively (FYE16: R117m and R180m).
- Unauthorised expenditure: R245m unauthorised expenditure on items such as impairments; depreciation; finance charges, transfers and grants due to the increase in the indigent register and transfers between operating and capital expenditure. At FYE16, only R22m in authorised expenditure was reported.
- Significant uncertainty: BCMM was a defendant in a number of lawsuits to the amount of R153m at FYE15. This had risen to R173m at FYE16.

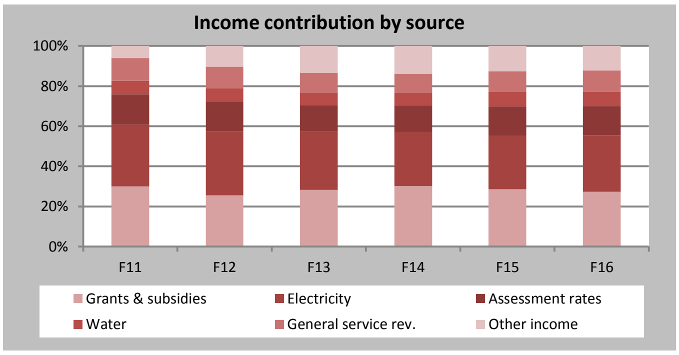
In addition, the AG has raised concern about the large historical balance of irregular expenditure. At FYE16, BCMM reported an irregular expenditure balance of R1.6bn (FYE15 R1.7bn), which has not been condoned. BCMM has argued that the amount should be written off as a full investigation would prove onerous and expensive, and is unlikely to lead to a recovery of income for the metro. Nevertheless, BCMM has cut irregular expenditure, with only R198m in irregular expenditure in F16, compared to R553m in F15. While GCR has noted the above findings, most matters are steadily being addressed.

Sources of income

Table 2: Sources of income (F16)	Industry*	BCMM		
	%	%	R'm	△%
Assessment rates	19.7	14.5	865.2	8.9
Electricity	37.7	28.3	1,694.3	15.6
Water	10.5	7.1	425.3	7.9
General services	8.8	10.5	630.1	11.6
Grants & subsidies	14.5	27.3	1,634.1	4.5
Other income	8.8	12.3	736.8	6.8
Total	**100.0**	**100.0**	**5,985.7**	**9.4**

* Average of all metropolitan municipalities.

Total income advanced by 9% to R6bn in F16, below the review period, slowing the compound annual growth rate ("CAGR") to 14.8%. The F16 result was again supported by strong growth in electricity receipts, as well as a notable rise in assessment rates and general services income.



- **Grants and subsidies**

Grants and subsidies received from National Government increased by 5% to R1.6bn in F16, to account for 27% of income. This was well above the average for the eight metropolitan municipalities of 15%, implying a relatively high dependence on national government for income. This can be explained by the small size of the BCMM relative to other metros, given less economic diversification and its positioning in a relatively underdeveloped province of the country.

Unconditional grants mainly comprise of the equitable share grant, which is determined by formulas that take into account demographic and developmental factors and are therefore mainly used for indigents. BCMM provides services to around 83,000 indigents, this excludes the new demarcated areas. These customers get a R486 rebate per month for rates and services. This is expected to be enough for responsible usage and the customer is liable for payment if this is exceeded. The second major grant item derives from the urban settlement development grant, and is designed for the provision of infrastructure in poorer areas. This includes electricity (internal services), sanitation and road infrastructure, as well as funds spent on RDP housing (while the HSDG is spent on top structure of RDP housing).

Table 3: Grants and subsidies	F15		F16	
	R'm	%	R'm	%
Operating projects	93.9	6.0	296.2	18.1
Housing projects	194.4	12.4	0.4	0.0
Property, plant and equipment	615.5	39.4	670.4	41.0
Unconditional	660.3	42.2	667.1	40.8
Total	**1,564.0**	**100.0**	**1,634.1**	**100.0**

BCMM reported a R211m unspent conditional grant balance at FYE16 (FYE15: R192m), albeit an improvement from the review period balance of R588m reported at FYE12. At FYE16, 75% of the balance related to Land Affairs accounting for R159m. Of the 25% balance of unspent conditional/unconditional grants, National Treasury approved 5% of the conditional grants to be rolled over into the F17.

- **Assessment rates**

Table 4: Property valuations (R'm)	F15	F16
Residential	46,111.8	47,221.5
Commercial	17,470.6	17,292.3
Public benefit organisation	27.6	55.7
Municipal	2.5	9.4
Rural communal land	3,120.4	2,985.0
Educational	1,701.6	1,644.1
Agricultural	3,013.0	2,932.3
Public service infrastructure	781.1	665.2
Vacant land	3,565.6	3,359.6
Total	**75,794.3**	**76,165.0**

Assessment rates are the third largest contributor to the council's revenue base (at an unchanged 15% in F16), and form a critical underpin for the metro's earnings. Rates income rose by 9% to R865m in F16. This was achieved on the back of average tariff increases of 9.9%. Whilst there was no change to municipal valuations, the gross value of residential property rose by almost R1bn in F16, compared to slight decreases for commercial and agricultural property valuations. As tariffs for commercial land are higher than for residential property, this had a slight dampening effect on overall rates income.

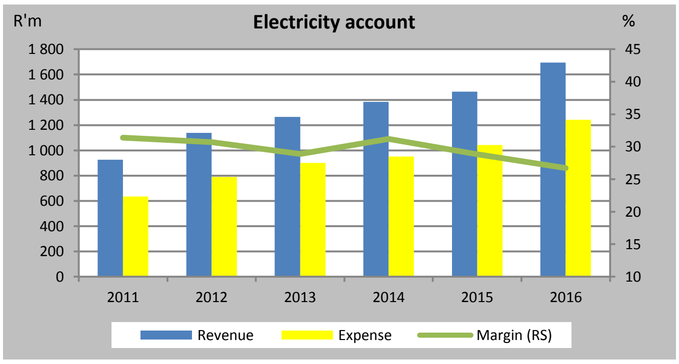
Given the increasing strain felt by the general population, the relatively high tariff increase in F16 will not be sustainable going forward. Nevertheless, tariff increases are expected to exceed inflation and range between 7%-8% over the next three years. The Municipal Property Rates Act requires that revaluations are conducted every four years. Accordingly, the next valuation will be in 2017 and will be implemented from 1 July 2018.

- **Electricity**

Since the load shedding problems impacted South Africa in 2008, electricity has been one of the fastest rising income streams for all municipalities. This has been underpinned the steep double digit tariff increases implemented by Eskom between F09 and F13 to help finance the maintenance of its aging power generation fleet, and the construction of the large new power stations. Thus, electricity revenue has comprised between 27%-30% of income over the review period, sustainably higher than the 25% level prior to F09.

At R1.7bn, electricity revenue was the largest single income component in F16 (F15: R1.5bn), and representing a CAGR of 13% over the five year review period. However, this has been accompanied by even steeper growth in bulk electricity costs, as a result of which the margin on the electricity account has been reduced markedly from 30.7% in F12 to 26.7% in F16 (F15: 28.8%). This curtailed profitability also derives from high electricity distribution losses. BCMM reported distribution losses of 14.53% or R180m in F16 (F15: 15.8% or R163m), with technical losses unchanged at 6.5%, and non-technical losses (arising from theft, faults, billing errors) slightly improved at 8.03% from 9.3% in the previous year. The improvement is positively noted, particularly in light of the growing problem of electricity theft. BCMM has embarked on a programme to decrease electricity losses.

The majority of BCMM's residential customers now receive pre-paid electricity, with only 5,795 residents (generally from more affluent areas) on conventional metres. Nevertheless, a study is underway to evaluate the possibility of changing businesses that are not on AMR to AMR metering to allow real time measurement of usage and tariffs by both consumers and the metro. This will also further aid in curtailing losses and ensuring more timeous payment.



- **Water**

BCMM is the Water Services Authority ("WSA") for its entire area of jurisdiction, as well as the bulk Water Services Provider for a large percentage (around 80%) of the municipal area. The metro also continues to distribute a substantial portion of water free of charge to indigent populations (6*kl* per month).

Water purchases have increased on average by 10%, however, BCMM's charge to consumers only increased by 8%. This saw revenue from water rise by 20% in F14 and 21% in F15. Nevertheless, water income increased by a more modest 8% to R425m in F16. This, together with the deterioration in non-technical water losses (increasing to R31m from R13m), saw the water profit margin narrow to 56.4% from 56.8% in F16. Cognisance is taken of the 30% technical losses reported by BCMM, albeit his is the norm and standard used by National Treasury. BCMM has disclosed that the actual distribution percentage loss is higher than 30%. Such high losses are attributable to supplying water to rural areas via a standpipe connection, aging infrastructure of water distribution network (BCMM has a programme in place to renew the infrastructure) and illegal connections. Going forward, BCMM contemplates expanding the production of own water resources which will be cost effective to its consumers.

- **Other income**

Other income consists of a miscellany of revenues including fire levy charges, commissions, vehicle registration charges, public contributions & donations, licences & permits and equipment rentals. It has made up a much larger portion of income in recent years, rising to 12% in F16 from 6% reported in F11. BCMM reported 7% growth in other income to R737m in F16, behind the five year CAGR of 32%.

Expenditure

Table 5: Expenditure (F16)	Industry %*	%	Actual R'm	Δ %	Budget R'm
Salaries and wages	25.9	26.5	1,404.0	8.9	1,289.4
Electricity	32.2	23.4	1,241.9	19.0	1,201.8
Water		3.5	185.4	8.7	
Depreciation**	7.4	14.7	779.8	15.4	710.0
Grants & donat.	1.7	4.6	241.7	2.5	1,286.1
Other expenses	23.8	18.6	985.6	(0.3)	
Repairs & maint.		6.6	350.1	21.8	
Bad debts	7.2	4.0	210.1	(42.5)	203.1
Net interest	1.8	(1.9)	(99.8)	n.a	59.2
Total	**100.0**	**100.0**	**5,298.8**	**2.6**	**4,749.7**

* GCR estimate based on metro results.
** Including asset impairments.

BCMM's expenses have risen at a CAGR of 10.1% over the review period, less than the growth in income. To this end, strict costs controls contained the increase in F16, with total expenditure increasing by just 3% to R5.3bn (compared to the 9% growth in income). Key cost drivers have remained salaries & wages and bulk electricity costs, in line with the industry norm. In this regard, staff costs rose by 9% to R1.4bn in F16 (this includes both inflationary increases as agreed by SALGA and the filling of new posts in terms of BCMM's approved organogram). Of this, basic emoluments rose by a moderate 5%, but overtime payments remained high, increasing by 9% to account for 10% of total staff costs. Staff costs were inflated by further steep increases in post-retirement costs. Overall, as a percentage of total expenditure, staff costs increased to 26.5% (F15: 25.9%), remaining in line with the average for all metros and below GCR's benchmark of 35%. No major vacancies that would impact service delivery were noted, although technical positions within electricity and water are always becoming vacant due to staff churn.

In line with best practice, BCMM now provides for debtors in line with the likelihood of payment by each debtor. However, this necessitated the metro to change the impairment methodology and thus, bad debt charges reported an upward trend since F11, to peak at R365m in F15. As provisions are now at suitable levels, a lower charge of R210m was incurred in F16, reflecting the more normalised bad debts experience.

While depreciation increased by 15% to R780m in F16 (ahead of the five-year CAGR 8.5%), repairs and maintenance rose by a higher 22% to R350m, reflecting greater effort to maintain existing infrastructure. Note is taken of the relatively low quantum of repairs and maintenance compared to depreciation, but BCMM indicated that much of the replacement and refurbishment activity is done as part of capex. In this regard, BCMM reserves cash against its depreciation charge, which is often used to refurbish and renew infrastructure assets, thereby extending the useful life of the infrastructure. GCR also notes that assessments to test the useful life of assets, and thus the appropriateness of deprecation, are undertaken annually or biannually.

Financial performance

A five-year financial synopsis for BCMM is reflected at the back of this report and brief comment follows.

Since F13, BCMM has recorded surpluses in each year under review, with the net surplus rising by 41% to R687m in F16. Included in this was R100m in net interest income, a review period high. This was the result of a significant increase in interest income, on the back of the higher cash balance.

Cash generated by operations has risen substantially since BCMM's conversion to a metro in F11, rising from R631m in F11 to reach R1.6bn in F16 (F15: R1.5bn). BCMM reported a R252m working capital absorption during the year (F15: R530m), underpinned by a R577m movement in debtors which was partially offset by a R330m release from exchange transaction payables. Despite debtors' driven working capital absorptions, cash flow from operations has been strongly positive over review period, reaching R1.4bn in F16 (F15: R1bn). Accordingly, operating cash flow coverage of gross interest rose to 22.5x from 8.3x in F12 (F15: 15.1x).

Net capex registered at a higher R1.1bn in F16 (F15: R924m) and was comfortably met by internal cash flows. BCMM spent 78% (F15: 80%) of its F16 mid-year adjusted capital budget of R1.4bn (F15: R1.2bn), while this depicts a regression in terms of percentage compared to F15, the value spend in real terms was high.

Table 6: Capex & funding budget (R'm)		Budget		
	F16*	F17	F18	F19
Infra. capex	**1,390.9**	**1,558.1**	**1,720.8**	**1,778.0**
Governance	46.5	40.7	44.9	30.7
Community	265.8	276.5	255.7	255.7
Economic	427.3	542.0	578.8	678.9
Services & other	651.3	698.9	841.5	812.7
Capex funding	**1,390.9**	**1,558.1**	**1,720.8**	**1,778.0**
Internal funding	600.8	640.3	638.7	631.6
Grants funding	790.1	848.3	892.8	969.5
External funds	-	69.6	189.4	176.9

* Unaudited.

Capex is projected to rise to R1.6bn and R1.7bn in F17 and F18 respectively. The aggressive capex targets reflect the substantial development needs of the metro, although even where funding is available, the metro has to operate within its capacity to deliver. Thus, capex is incrementally being increased as the necessary capacity is developed within the metro. In addition to the development of service delivery infrastructure, the municipality's capex is also directed towards economic stimulus and job creation. As in preceding years, expenditure will be focussed on economic and trading services development. The largest items pertain to waste water (24%), as well as roads & storm water (17%), with the remainder largely comprised of capex on electrical infrastructure and transport planning.

Major projects underway cut across all segments of service delivery and include R436m for a sewer tunnel, R132m for the Integrated Transport Programme, as well as the upgrading of waste water treatment works (R130m), and of highways. These projects are budgeted to be financed with grants and, to a lesser extent, internally generated funds.

Funding profile

BCMM's fixed assets have increased from R10.2bn at FYE12 to R12.8bn at FYE16 and account for 75% of the balance sheet. The majority of investment activity has been funded internally or through grants, which has seen the metro's accumulated surplus increase substantially over the review period, rising from R10.5bn at FYE12 to R14.9bn at FYE16 (FYE15: R13.8bn). While the accumulated surplus is comparable to the equity of a private company, the value is underpinned by immovable property, which does not generate income and cannot be liquidated or pledged by the municipality.

BCMM continues to report substantial cash holdings, which increased to R2.4bn at FYE16 (FYE15: R2.2bn), driven by retained cash of R169m following capex and debt repayment costs. As indicated, ensuring there is sufficient cash to meet repairs and infrastructure development costs has been a primary focus of the metro, and has resulted in BCMM reporting strong net cash positions, as well as low debt usage in all years under review. Cash holdings are evenly diversified amongst five banks and all cash is held in short term deposits. Of the cash, R211m related to unspent conditional grants (FYE15: R192m), well behind the high of R588m reported at FYE12, and thus free cash remained strong at R2.2bn at FYE16 (FYE15: R2bn). Excluding the unspent grants, days cash on hand was reported at 151 days (FYE15: 154 days). Accordingly, the metric has remained well ahead of GCR's internal benchmark of 90 days since FYE13. Similarly, free cash coverage of debt was strong at 4.4x at FYE16 (FYE15: 3.7x). The current ratio of 2.1x at FYE16 (FYE15: 2.3x.) also indicated ample liquidity.

Table 7: Liquidity position (R'm)	FYE12	FYE13	FYE14	FYE15	FYE16
Total cash	1,522.0	1,841.7	2,162.7	2,198.8	2,373.9
Unspent conditional grants	(588.2)	(450.1)	(213.7)	(191.5)	(211.3)
Free cash	**933.8**	**1,391.5**	**1,949.0**	**2,007.3**	**2,162.6**
Days cash on hand (total)	154.7	174.3	182.7	169.2	165.3
Days cash on hand (ex cond. grants)	94.9	131.7	164.6	154.4	150.5
Free cash coverage of debt (x)	1.4	2.1	3.2	3.7	4.4

Given the strong cash generation evidenced by BCMM over the review period, it has maintained low levels of interest-bearing debt. Gross debt decreased to a new low of R497m at FYE16 (FYE15: R546m), as debt was settled in line with scheduled repayments. BCMM's loans have been provided by RMB and DBSA and are amortising in nature. While 10% of the debt was considered as short term at FYE16, this largely relates to the current portion of long term facilities. Even on a gross basis, the ratio has followed a downward trend, with gross debt to total income at just 8% at FYE16 (FYE15: 10%), from 18% at FYE12.

Debtors book

While net debtors are not a substantial proportion (6%) of BCMM's asset base, the underlying consumers are the key drivers of the municipality's revenue and the book's performance has a strong bearing on operating cash flows. Municipalities have historically been burdened with a substantial proportion of non-performing loans. While in many cases this is the result of indigent debtors who should receive services free of charge, it has also stemmed from billing errors and a general non-payment culture. As non-payment (or late payment) affects the cash flows of the municipality, where debtors are particularly high, service delivery tends to be poor, exacerbating the non-payment cycle.

Table 8: Debtors	FYE15		FYE16*	
	R'm	%	R'm	%
Rates	328.4	23.8	422.7	23.6
Electricity	199.9	14.5	226.3	12.7
Water	378.2	27.4	479.8	26.8
Sewerage	148.7	10.8	181.3	10.1
Refuse	190.4	13.8	240.6	13.5
Other	135.4	9.8	237.6	13.3
Gross cons. debtors	**1,380.9**	**100.0**	**1,788.3**	**100.0**
Less provisions	(971.7)	-	(1,097.3)	-
Net cons. debtors	**409.2**	**58.9**	**691.0**	**66.8**
Other debtors	285.5	41.1	343.9	33.2
Total net debtors	**694.8**	**100.0**	**1,034.9**	**100.0**

* Unaudited.

Consumer and exchange transaction debtors have continued to grow as a result of higher tariffs and debtor delinquency. This has seen the collective net debtors balance rise to R1bn at FYE16 (FYE15: R695m), from R314m ten years ago. As such, the ratio of gross debtors to total income edged upwards to 26% (F15: 23%).

Table 8 indicates that the consumer debtors book was concentrated to water (27% of the total) and rates (24% of the total), while electricity debtors only accounted for 13% of the total. The low level of electricity debtors could be explained by the high proportion of prepaid metering and electricity sold to large corporates (who tend to pay on time). Nevertheless, the distinction in consumer debtors (aside from electricity) is somewhat arbitrary as most residents and businesses receive a single municipal account. Thus, when partial payment is made, it is allocated first to rates, then to water and other services, and lastly to electricity (for post-paid users). This helps BCMM enforce full payment as it has have the ability to cut off electricity if there are amounts outstanding. Consumers comprised 74% of the gross book in F16 (F15: 78%), with commercial debtors representing 25%, and government 1%. Thus, around 79% of the impairments relate to domestic consumers. Low government debtors are a reflection of the benefits of the dedicated government debtors management function within the metro.

Table 9: Debtors age analysis	FYE15		FYE16*	
	R'm	%	R'm	%
Current (0-30 days)	323.5	23.4	382.6	21.4
31-60 days	69.9	5.1	76.4	4.3
61-90 days	46.2	3.3	47.4	2.6
91-120 days	37.4	2.7	48.1	2.7
121-365 days	251.9	18.2	326.1	18.2
365+ days	652.0	47.2	907.8	50.8
Total	**1,380.9**	**100.0**	**1,788.3**	**100.0**

* Unaudited.

Whilst relative shifts in the debtors aging buckets are generally small in a given year, they can have a noticeable cash flow impact as the amounts are large. An analysis of the debtors aging profile evidenced the underperformance of collections. Of concern is the persistence of debtors outstanding more than 120 days (69% of the total), which continues to expand. While this has partly been driven by interest accrued on outstanding amounts, new debtors originated have also contributed to the relative increase. BCMM has applied for approval from the metro's council to have long outstanding debtors written off, but for F17 only R275m has been applied for write off.

GCR notes the measures being taken by BCMM to improve debtors' collection. This includes the aforementioned consolidation of bills so that customers receive a single municipal account. BCMM has also started sending out payment reminders to customers on the 15th of every month. Such measures have resulted in the municipality reporting a collection rate of over 90%, albeit that at levels below 100% debtors will continue to rise. During F16, BCMM undertook a scheme to encourage consumers to pay long outstanding debts, by offering discounts to customers who were maintaining their current payments up-to date. However, the scheme has not been as successful as anticipated.

Operating estimates and capital expenditure

Table 10: Tariff increases (%)	F16	F17	F18	F19
		Budget		
Assessment rates	9.90	7.60	7.20	7.00
Refuse	9.50	7.80	7.50	7.20
Sewerage	9.50	7.80	7.50	7.20
Water	11.00	8.00	7.89	7.92
Electricity	12.20	7.64	7.64	7.64
Fire Levy	9.90	7.60	7.20	7.00
Sundry Income	9.90	7.60	7.20	7.00

Total income is expected to rise by 13% to R6.8bn in F17, and thereafter by 8% to reach R7.3bn in F18. Revenue growth is expected to be underpinned by rates and electricity income, as well as growth in both operating and capital grants recognised to revenue. To this end, tariff increases for the next three years have been set slightly above CPI, to ensure services produce revenue sufficient to cover the rising costs associated with providing the services.

Expenditure is expected to reflect similar increases to that of revenue, with total spend expected to rise by 11% in F17, and 8% in F18. Staff costs are budgeted to rise by 13% in F17 (slightly above overall income), but thereafter a more moderate 7% is projected for F18. Bulk purchases are budgeted to be 7% higher in F17, and 8% higher in F18, due mainly to higher tariffs from the utility companies. Overall, BCMM is budgeting for surpluses of R858m in F17 and R895m in F18.

Table 11: Operating performance (R'm)	Budget		
	F16	F17	F18
Rates	865.2	1,122.9	1,203.8
Electricity	1,694.3	1,815.3	1,953.9
Water	425.3	444.3	479.4
Other serv. charges	630.1	669.1	719.2
Grants & subsidies	1,634.1	2,177.0	2,343.2
Other income	736.8	535.5	572.7
Total income	**5,985.7**	**6,764.1**	**7,272.2**
Staff costs	(1,404.0)	(1,589.2)	(1,703.6)
Bulk purchases	(1,427.3)	(1,521.6)	(1,645.6)
Depreciation	(779.8)	(748.3)	(794.7)
Net interest	99.8	57.1	70.9
Bad debts	(210.1)	(303.9)	(326.7)
Grants & don.	(241.7)	(288.5)	(310.2)
General expenses	(1,335.7)	(1,511.3)	(1,667.8)
Total expenditure	**(5,298.8)**	**(5,905.7)**	**(6,377.7)**
Surplus/(deficit)	**686.9**	**858.4**	**894.5**

Conclusion and rating rationale

BCMM continues to be impacted by the weak economic environment and particularly by the challenges facing the industrial sector. This had constrained economic activity in the region and added to the burden of providing services to indigent residents. While the metro continues to report strong income growth, this has been primarily driven by rising tariffs which may not be sustainable over the medium term. As a consequence, the metro faces a relatively high incidence of bad debts.

A further concern is pressure of the "qualified" audit reports from the AG, irregular expenditure and capex commitments. Notwithstanding progress at improving compliance, the amounts included under irregular expenditure remain relatively high. Improving the audit outcome will thus be critical to positive rating movement.

BCMM's greatest credit strength is its strong net cash position. Gross gearing metrics have been negligible over the review period, while days cash on hand is well ahead of GCR's benchmark. The cash position has also provided the financial strength for BCMM to undertake infrastructure upgrades and extensions without needing to rely on government grants. This is particularly salient as indications from National Government are that municipalities will increasingly be viewed as independent entities that will need to be self-sustainable. As such, operating grants to support indigent residents (like the equitable share grant) are likely to persist indefinitely, but government will increasingly expect municipalities to fund capital expenditure out of their own resources and through external funding. Such a robust liquidity position is characteristic of a highly functioning metro.

Buffalo City Metropolitan Municipality

(R in Millions except as Noted)

INCOME STATEMENT Year end: 30 June	2012	2013	2014	2015	2016
Tax revenues	522.5	580.1	673.0	794.5	865.2
General service revenues	378.0	427.4	489.7	564.7	630.1
Trading service revenues	1,376.7	1,536.9	1,709.2	1,860.1	2,119.6
Other income	1,276.7	1,820.5	2,251.8	2,252.8	2,370.9
Total income	**3,554.0**	**4,364.9**	**5,123.7**	**5,472.1**	**5,985.7**
Bad debt write-offs and provisions	(58.2)	(106.8)	(241.0)	(365.1)	(210.1)
Expenses	(3,520.9)	(3,788.9)	(4,255.3)	(4,683.5)	(5,188.5)
Net interest & capital charges	(23.9)	16.7	30.7	63.5	99.8
Net surplus/(deficit)	**(49.0)**	**485.9**	**658.1**	**486.9**	**687.0**
BALANCE SHEET					
Funds, reserves & accumulated surplus	**10,538.8**	**11,032.5**	**13,375.0**	**13,796.8**	**14,880.0**
Short term debt	42.0	51.7	57.4	48.8	50.7
Long term debt	605.2	600.8	546.0	497.2	445.8
Total debt	**647.2**	**652.5**	**603.4**	**546.1**	**496.5**
Non-interest bearing liabilities	1,570.3	1,410.1	1,314.2	1,292.8	1,702.1
Total Liabilities	**12,756.3**	**13,095.1**	**15,292.6**	**15,635.7**	**17,078.6**
Fixed Assets & WIP (net of loans redeemed & other capital receipts)	10,189.4	10,087.5	11,828.6	11,987.0	12,847.2
Investments & other (excl. cash investments)	373.5	368.6	541.3	558.2	617.9
Net debtors	458.8	596.2	577.4	694.8	1,034.8
Inventory	117.1	71.7	50.6	44.9	36.0
Cash & cash investments*	1,522.0	1,841.7	2,162.7	2,198.8	2,373.9
Other current assets	95.5	129.4	132.0	152.1	168.8
Total Assets	**12,756.3**	**13,095.1**	**15,292.6**	**15,635.7**	**17,078.6**
CASH FLOW STATEMENT					
Cash generated by operations	506.6	1,239.7	1,039.3	1,283.3	1,298.3
Utilised to increase working capital	90.5	(42.6)	(82.6)	(269.9)	70.6
Cash flow from operations	**597.1**	**1,197.1**	**956.8**	**1,013.4**	**1,368.9**
Net capital expenditure	(211.6)	(590.3)	(564.3)	(923.8)	(1,149.4)
Net investment activity (excl. cash investments)	442.3	(291.1)	(21.1)	3.8	0.0
Borrowings: increase / (decrease)	(46.1)	5.2	(49.1)	(57.3)	(49.6)
Cash and cash investments : (increase)/decrease	(781.8)	(321.0)	(322.2)	(36.1)	(169.9)
Net debt: increase/(decrease)	**(827.8)**	**(315.8)**	**(371.3)**	**(93.4)**	**(219.5)**
KEY RATIOS					
Credit Protection Measures:					
Gross interest cover (x)	(0.4)	7.0	9.5	7.0	10.7
Net interest cover (x)	(1.1)	n.a.	n.a.	n.a.	n.a.
Operating cash flow interest cover - gross (x)	8.3	17.2	13.7	15.1	22.5
Operating cash flow : net debt (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Total debt : capital outlays (%)	6.4	6.5	5.1	4.6	3.9
Total debt : total income (%)	18.2	14.9	11.8	10.0	8.3
Net debt** : total income (%)	n.a.	n.a.	(26.3)	n.a.	n.a.
Net capex : total income (%)	6.0	13.5	11.0	16.9	19.2
Current ratio (:1)	1.4	1.8	2.1	2.3	2.1
Days cash on hand (days)	154.7	174.3	182.7	169.2	165.3
Days cash on hand (days) - excluding unspent conditional grants	74.6	131.7	164.6	154.4	150.5
Bad debt writeoffs : current debtors (%)	7.3	10.9	22.6	29.2	13.5
Efficiency:					
Trading income : total income (%)	38.7	35.2	33.4	34.0	35.4
Staff expenses : total expenses (%)	27.7	26.4	26.4	25.9	26.5
Staff expenses : total incomes (%)	28.1	23.5	23.0	23.6	23.5
Distribution loss - water (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Distribution loss - electricity (%)	n.a.	n.a.	n.a.	n.a.	n.a.
Debtors : tax, general & trading income (%)	20.1	16.3	12.5	10.1	11.9
Collection period (days)	73.5	59.3	45.8	36.7	43.3
Gross debtors: total income (%)	22.6	22.4	20.8	22.8	25.9
Net debtors: total income (%)	12.9	13.7	11.3	12.7	17.3
Growth Statistics:					
Increase in tax, gen. & trading income (%)	18.8	11.7	12.9	12.1	42.1
Increase in salaries and allowances (%)	13.1	2.7	15.0	9.2	36.9
Increase in debtors (%)	22.5	21.9	9.1	16.9	58.5
Increase in capex (%)	(46.1)	178.9	(4.4)	63.7	24.4
Increase in net debt (%)	n.a.	n.a.	n.a.	n.a.	n.a.

*Includes all unspent grants and subsidies.

Appendix A

NATIONAL SHORT TERM DEBT RATING SCALE:

GCR's Rating Symbols and Definitions Summary

A1+$_{(xx)}$	Highest certainty of timely payment relative to other issuers or obligations in the same country. Short-term liquidity, including internal operating factors and/or access to alternative sources of funds is high. Risk factors are extremely low relative to others in the same country.
A1$_{(xx)}$	Very high certainty of timely payment relative to other issuers or obligations in the same country. Liquidity factors are excellent and supported by good fundamental protection factors. Risk factors are minor.
A1-(xx)	High certainty of timely payment relative to other issuers or obligations in the same country. Liquidity factors are strong and supported by good fundamental protection factors. Risk factors are very small.
A2$_{(xx)}$	Good certainty of timely payment relative to other issuers or obligations in the same country. Liquidity factors and company fundamentals are sound. Although ongoing funding needs may enlarge total financing requirements, access to capital markets is good. Risk factors are small.
A3$_{(xx)}$	Satisfactory liquidity and other protection factors relative to other issuers or obligations in the same country. However, risk factors are larger and subject to more variation.
B$_{(xx)}$	Highly uncertain capacity for timely payment of financial commitments relative to other issuers or obligations in the same country. Liquidity is not sufficient to insure against disruption in debt service. Operating factors and market access may be subject to a high degree of variation.
C$_{(xx)}$	Possibility of not meeting financial commitments is highly likely relative to other issuers or obligations in the same country.
LD/DD$_{(xx)}$	Defaulted on one or more of its obligations, failing to meet scheduled principal and/or Interest payments (LD). Defaulted on all obligations, or is likely to default on all or substantially all of its obligations as they fall due, thus failing to meet all or substantially all scheduled principal and/or Interest payments (DD).

IMPORTANT NOTE: GCR differentiates its ratings assigned to obligations of a structured finance nature by adding an $_{(sf)}$modifier to such ratings. For example, AA$_{(sf)}$.

NATIONAL LONG TERM DEBT RATING SCALE:

GCR's Rating Symbols and Definitions Summary

AAA$_{(xx)}$	Highest credit quality relative to other issuers or obligations in the same country. The risk factors are extremely low relative to others in the same country.
AA+$_{(xx)}$ **AA**$_{(xx)}$ **AA-**$_{(xx)}$	Very high credit quality relative to other issuers or obligations in the same country. Protection factors are very strong. Adverse changes in business, economic or financial conditions would increase investment risk although not significantly.
A+$_{(xx)}$ **A**$_{(xx)}$ **A-**$_{(xx)}$	High credit quality relative to other issuers or obligations in the same country. Protection factors are good. However, risk factors are more variable and greater in periods of economic stress.
BBB+$_{(xx)}$ **BBB**$_{(xx)}$ **BBB-**$_{(xx)}$	Adequate protection factors relative to other issuers or obligations in the same country. However, there is considerable variability in risk during economic cycles.
BB+$_{(xx)}$ **BB**$_{(xx)}$ **BB-**$_{(xx)}$	Capacity for timely repayment exists, however, denotes elevated default risk relative to other issuers or obligations in the same country. Present or prospective financial protection factors fluctuate according to industry conditions or company fortunes. Overall quality may move up or down frequently within this category.
B+$_{(xx)}$ **B**$_{(xx)}$ **B-**$_{(xx)}$	Possessing risk that obligations will not be met when due relative to other issuers or obligations in the same country. Financial protection factors will fluctuate widely according to economic cycles, industry conditions and/or company fortunes.
CCC$_{(xx)}$	Considerable uncertainty exists as to timely payment of principal or interest relative to other issuers or obligations in the same country. Protection factors are narrow and risk can be substantial with unfavourable economic/industry conditions, and/or with unfavourable company developments.
LD/DD$_{(xx)}$	Defaulted on one or more of its obligations, failing to meet scheduled principal and/or Interest payments (LD). Defaulted on all obligations, or is likely to default on all or substantially all of its obligations as they fall due, thus failing to meet all or substantially all scheduled principal and/or Interest payments (DD).

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S CORPORATE SECTOR GLOSSARY

Bad Debt	A bad debt is an amount owed by a debtor that is unlikely to be paid due, for example, to a company going into liquidation. There are various technical definitions of what constitutes a bad debt, depending on accounting conventions, regulatory treatment, and the individual entity's own provisioning and write-off policies.
Balance Sheet	Also known as Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capital	The sum of money that is invested to generate proceeds.
Capital Expenditure	Expenditure on long-term assets such as plant, equipment or land, which will form the productive assets of a company.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Current Ratio	A measure of a company's ability to meet its short-term liabilities and is calculated by dividing current assets by current liabilities. Current assets are made up of cash and cash equivalents ('near cash'), accounts receivable and inventory, while current liabilities are the sum of short-term loans and accounts payable.
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 investments, 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.
Economic Indicators	Statistical data about country's economy, such as unemployment figures, the Consumer Price Index (CPI), Gross Domestic Product (GDP), money supply and housing statistics. This data gives information about the future direction of output and demand in an economy.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Fixed Assets	Assets of a company that will be used or held for longer than a year. They include tangible assets, such as land and equipment, stake in subsidiaries and other investments, as well as intangible assets such as goodwill, information technology or a company's logo and brand.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA.
Impairment	Reduction in the value of an asset because the asset is no longer expected to generate the same benefits, as determined by the company through periodic assessments.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
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	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Mandate	Authorisation or instruction to proceed with an undertaking or to take a course of action. A borrower, for example, might instruct the lead manager of a bond issue to proceed on the terms agreed.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Operating Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
Performing Loan	A loan is said to be performing if the borrower is paying the interest on it on a timely basis.
Pledge	An asset or right delivered as security for the payment of a debt or fulfillment of a promise, and subject to forfeiture on failure to pay or fulfill the promise.
Receivables	Any outstanding debts, current or not, due to be paid to a company in cash.
Revaluation	Formal upward or downward adjustment to assets such as property or plant and equipment.
Short-Term Rating	A short term rating is an opinion of an issuer's ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Term Deposit	A savings account held for a fixed term. Also called a time deposit. Generally, there are penalties for early withdrawal.
Working Capital	Working capital usually refers to the resources that a company uses to finance day-to-day operations. Changes in working capital are assessed to explain movements in debt and cash balances.

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SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the rating was influenced by any other business activities of the credit rating agency; b.) the rating was based solely on the merits of the rated entity, security or financial instrument being rated; c.) such rating was an independent evaluation of the risks and merits of the rated entity, security or financial instrument; and d.) the validity of the rating is for a maximum of 12 months, or earlier as indicated by the applicable credit rating document.

Buffalo City Metropolitan Municipality participated in the rating process via face-to-face management meetings, teleconferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible.

The credit rating/s has been disclosed to Buffalo City Metropolitan Municipality with no contestation of the rating.

The information received from Buffalo City Metropolitan Municipality and other reliable third parties to accord the credit rating(s) included;

- Audited financial results per 30/06/2015
- Unaudited financial results per 30/06/2016
- 5 years of comparative numbers
- A breakdown of facilities available and related counterparties
- Industry comparative data

The ratings above were solicited by, or on behalf of, the rated client, and therefore, GCR has been compensated for the provision of the ratings.